CASE PROBLEMS IN FINANCE

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Since all the cases in this book have been revised or written by the authors, we accept full responsibility for the contents of this volume.

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INTRODUCTION

Introduction
The Uses of Case Problems

Since it is likely that many readers have not worked with case problems before, we will describe in this introduction what case problems are and what advantages we feel can be gained from their use.

Each of the cases in this book represents a statement of an actual business situation. In almost every case a businessman is confronted with a financial problem which calls for decision on his part. Sufficient background information is given in each case to enable the student to adopt the point of view of the person facing the problem and to work out a sensible analysis looking toward action on the problem presented. It is expected that students will have available a standard finance text or reference book and that they will draw freely upon such a book for general background information not provided in this casebook.

Reference to the Table of Contents will indicate that the cases selected represent problems in most of the major areas covered in finance courses. It will be apparent that the authors have given especial emphasis to certain areas which, in the authors' view, are inadequately treated in the leading texts. This is particularly true of the area of "financing current operations."

Although most of the cases are taken from the recent experiences of business, some cases from years of cyclical decline and depression have been included. Also, in selecting the cases for inclusion in this volume an effort was made to tap the experiences of businesses in widely different fields. Finally, the reader will find that a large number of cases involve small- and medium-sized businesses and that only a few refer to the largest corporations.

This case material is prepared as a basis for class discussion. It is not

designed to present either a correct or an incorrect illustration of the handling of administrative problems.

The authors realize that the time available for work with these cases will vary widely. Since some instructors may desire to take up only a portion of the cases in this book, almost all the cases are so written that they can be taken up independently.

In regard to advantages that we feel can be derived from the use of case problems, perhaps their greatest value is that they require the student to work through to a recommendation for action. He cannot stop with an understanding of the facts of the case or with a listing of the matters to be considered. To be effective, he must actually think through to a decision suitable to the facts, and in class discussion he must be able to present and defend his ideas and judgment against the ideas of others. The need to reach a conclusion from the facts at hand and to discuss it intelligently is a great force in learning, helping to provide that elusive quality of "depth" that is often missed when learning is restricted to the reviewing of facts and views that others have codified.

Since the cases in this book represent business situations selected so as to present debatable alternatives of action, they present problems which can be narrowed by the usual techniques but not settled by any mechanistic approach. Judgment must enter into the process of decision making, and therefore unanimous agreement as to the best decision is neither an expected nor a desired result of class meetings. Students accustomed to work with technical or scientific problems, where precise and definite conclusions can be reached with confidence, may find at first that the absence of a single "right" answer to many of the issues presented in these cases is disturbing and even frustrating.

In developing a logical approach toward the problems presented, the student should not overlook the human factors. In many, if not all, of the cases the choice between financial alternatives depends in part upon the particular viewpoints of the personalities involved, particularly with reference to their willingness to take risks. An apocryphal anecdote may be cited in support of the need for full recognition of personal factors in financial questions. It is said that the late Baron Rothschild, during his prime as a leader of finance in London, was visited by a young man who had recently become the heir of a large estate formerly in the control of a personal friend of the Baron's. "Sir," the young man said, "my father told me to seek your advice about how to invest the funds which have

come to me." The Baron looked at him for a moment and then said, "Young man, do you wish to eat well or sleep well?"

While work with cases may in some instances require more of the student's time than mere reading requires, the satisfaction of dealing with problems which help to bridge the gap between classroom study and business action and the zest of thinking for one's self are usually adequate recompense for any extra time employed.

PART 1

FINANCING CURRENT OPERATIONS

English Motor Sales, Inc.

Early in September, 1948, Mr. Gordon Campbell moved from the position of new car sales manager of English Motor Sales, Inc., to become treasurer of the corporation. Although Mr. Campbell had held the post of bookkeeper for the company early in his 20 years of continuous work with the firm, he had never before had occasion to consider how the problems of a treasurer might change his point of view toward the activities and policies of the company.

English Motor Sales, Inc., held an exclusive dealership franchise in a southeastern city for the Chevrolet Motor Company, a division of General Motors. New car sales varied between 250 and 500 units per annum. The business had been organized in 1928 by Mr. James English and Mr. Mark Herring. Although both men held an equal amount of the stock, only Mr. English participated actively. He had served as president of the company from its organization.

English Motor Sales, Inc., rented the building where it carried on its operations from a second corporation owned jointly by Mr. English and Mr. Herring.

In September, 1948, the activities of the auto sales firm were divided into departments as follows: (1) new cars, now under James Mitchell; (2) used cars, under Joe Waters; (3) service, under Robert Ellis; and (4) parts and accessories, under John Grant. All of the departmental managers had been employees of the firm for more than 15 years.

As he took up the work of treasurer, Gordon Campbell knew that it was the settled policy of the owners to develop and maintain a long-term business rather than to attempt to gain maximum short-run profits at the expense of customers and employees. Looking back over his experience in the early years, Mr. Campbell recalled that there had been almost continuous struggles to maintain solvency in the years 1928–1934. These had been reflected in strict economies, restriction of opportunity to de-

velop business, and the like. With this background, Mr. Campbell knew that the owners would want the financial management to avoid such a condition at any time in the future. But, while he recognized this goal clearly, Mr. Campbell was not sure how it might affect his policies as treasurer.

A forecast of the balance sheet position of the company at December 31, 1948, had been prepared by Mr. Campbell's predecessor and is shown as a pro forma statement in Exhibit 1 (p. 16). Mr. Campbell was much impressed by the large sum projected for the cash account, $34,650, especially in view of the large amount of U.S. Treasury bonds, $77,300, that also appeared. These bonds could be sold on the securities market with a slight profit over their book value, and the proceeds of sale could be received in cash within 24 hours. Thus, Mr. Campbell saw that the firm was expected to have $111,950 in cash, or the equivalent, at the end of the year. This would be over one-third of the total assets, and an increase of about $28,000 since the beginning of the year.

As sales manager, Mr. Campbell had been comfortably aware that the company was currently in a very liquid position, but in his new responsibility he wondered whether this high degree of liquidity was necessary or desirable.

The accounting records of English Motor Sales, Inc., were kept according to a standard system furnished to Chevrolet dealers by the General Motors Corporation. In this system, income and expense were allocated under the following department titles: (*a*) new car, (*b*) used car, (*c*) service, (*d*) parts and accessories, and (*e*) administrative. Observing that the projected income statement details were available for the year 1948, Mr. Campbell decided to have them at hand for possible guidance. The departmental budgets appearing in Exhibit 2 (p. 17) were confusing to Mr. Campbell, but he thought that some of the totals might be useful.

Mr. Campbell first thought of the activities of his former department, new car sales, with the idea of reviewing the operations from his new viewpoint. Market research indicated that, after providing for housing and insurance, the typical family considered an automobile the next purchase to be made. As automobiles had almost doubled in price since the 1930's, Mr. Campbell and Mr. Mitchell, the new sales manager, felt that the ability of sales personnel should be high in order to do a good job of selling in a market that was expected to become increasingly difficult. The problem of "overselling" also required high-grade personnel,

as the experience of English Motor Sales, Inc., in 1929 and 1930 made clear. Of the 399 new cars sold in 1929, 228 had been repossessed by the end of 1930.

Prior to the war, new car sales compensation had been solely on a 2.5% to 3% commission basis. The normal year being seasonal, this scheme of pay had made sales personnel insecure and consequently unreliable. In the postwar years, it had not been necessary to have salesmen. The sales manager and other salaried personnel handled the sales work.

As the company's experience indicated that three or four good men would account for most of the new car sales in a competitive year, Mr. English and Mr. Campbell had worked out a plan for salaried salesmen, one to be hired for each 100 new cars to be sold in a year. The men were to be paid $250 and expenses per month, with commissions over a sales quota. A good man could expect to gross at least $8,000 in a good year. The institution of this policy, however, awaited the development of a more nearly "buyers' " market.

In 1948, James English was running an inventory of about a dozen new cars, but Mr. Mitchell thought there should be a stock of at least 50 new cars as soon as the supply-demand situation permitted. In ordinary years, sales were lost if a customer had to wait long for his car.

It was the established custom of the trade for the retailer to pay the manufacturer "at sight" upon receipt of shipments of cars. While established dealers, such as English Motor Sales, Inc., could borrow from local banks to pay for the new cars as they were received into the inventory, the interest rate formerly paid by the firm was 8%, which Mr. Campbell thought was quite high.

Often the purchasers of new cars found it necessary to borrow part of the purchase price. Many banks and finance companies were glad to buy the retail notes so created, so that the dealer did not have to carry the customer. Mr. English, however, had adopted the policy of carrying the time payment notes of his best risks, as the gross rate of return on such notes ran from 12% to 9%. A full-time collector had been employed to supervise these loans, with the plan to keep such receivables to a level of $50,000 or more.

As sales manager, Mr. Campbell had been concerned about the adequacy of display and other storage space, for the parts department had expanded to occupy most of the building formerly allocated to the sales department. Mr. English had indicated that he might approve a plan of expansion, if co-ordinated with the needs of the other depart-

ments. There had been no discussion of whether the expansion would be owned or rented. Mr. English had indicated great reluctance to build while building costs were at the current high levels. He understood that no contractor in the city was willing to do any work on a fixed price basis because costs were rising so rapidly.

After reviewing the program of the new car sales department, Mr. Campbell considered the nature of the operations of the other departments of the business. Under prewar conditions, a used car department was regarded as a necessary evil by the retail automobile dealer. Often the "trade-in" represented the dealer's profit in the new car sale and there was pressure to dispose of used units rapidly. In general, a used car department was regarded as being successful if it "broke even" in its operations. Thus Mr. Waters, who became used car manager in 1936, was praised for producing a gross profit, totaling $2,202 for the six years, 1936–1941.

In the English company, the new car manager appraised the car to be traded. The car was then transferred to the used car department with the allowance value as the cost of the car. The used car manager decided what repairs to make, and these were added to the cost. The used car manager also set the selling price. The subsequent sale might produce another traded car or might be for cash. Used cars could be financed in a manner similar to time sales financing of new car sales.

From the resumption of new car sales in November, 1945, until September, 1948, 92 used cars had been sold with a gross profit of $10,714. This amounted to an average of $117 gross profit per unit; yet the used car department operated at an average net loss of $65 per month. This was the result of a policy of fair treatment of customers, on which Mr. English insisted, to maintain the long-run standing of the company. Trade-ins were not insisted upon when new cars were sold.

Prior to the war the department had been operated with two mechanics and six salesmen in addition to Mr. Waters. Mr. Waters planned, however, to add two or three salesmen shortly and to adopt the scheme proposed for the new car department. The salary would be $220 per month, with the quotas set to produce an equal amount per month by commissions averaging $20 per car.

New car sales being seasonal, the inventory of used cars varied accordingly. Prewar experience showed that the inventory ran 1½ times the number of new cars sold in the preceding month. The average cost, prewar, had been $250 per car. In 1948, the average was $600.

As a successful manager, Charles Waters knew that his primary job was to turn used cars into cash as rapidly as possible. General Motors stated that a 20-day cycle was the optimum period. Mr. Waters had always been persistent in his resistance to the tendency of merchants to retain an article indefinitely rather than to take a loss. In fact, he was considering an "automatic" markdown plan, as had been adopted in some department stores.

On the other hand, Mr. Campbell recalled that in the 1930's, when the English company had been hard pressed for money, losses of the used car department had been increased by too much pressure to sell. Also, the development of independent used car lots had caused Mr. Waters to consider holding cars until a group had been accumulated, with the idea of selling them on a wholesale basis to one of the operators of the independent lots.

The used car department did business on a lot owned by the sales company, which was adjacent to the building that housed the other departments. Presumably, expansion of the building would use this lot.

The service department of English Motor Sales, Inc., had enjoyed recently a very high level of activity. In fact, the large profits of the firm in recent years could be attributed more to the service and parts departments than to car sales. A common test of success for retail automobile dealers is whether the gross profits of the service and parts departments are sufficient to absorb all the overhead costs of the firm. Then, with the used car department breaking even, the profit of the new car sales department after selling expense can be taken as profit of the firm. Referring to Exhibit 2, Mr. Campbell saw that this was approximately the condition of his company.

Experience during the war years caused owners to learn the serviceability of cars that were properly maintained. Even with new car production under way, the volume of demand for service had held at high levels until the summer of 1948, when there had been some slacking off. The best opinion available, however, indicated that the decline would not be a major one. Statistics indicated an average service of 90,000 miles by cars scrapped in 1948. This was an increase of 50% over prewar years.

The Chevrolet Motor Division of General Motors had considerable influence over the policies of the service departments of its dealers. It was a requirement of continuance of the dealership that service be available on an uncurtailed basis whatever might be the general eco-

nomic conditions. Also, the manufacturer had established standard labor costs for the more common service jobs. These had been established by studies of average workers working under average conditions. The times so established were used with a standard rate, which in the southern region was $2.00 per hour, to establish the labor cost of the job. The mechanic received 50% of this sum for his work, while the company took the balance. Although this system of incentive pay had been protested by the mechanics when it was installed in 1942, it had become popular, as efficient mechanics were often able to take home more per week than the supervisors.

The service department at English Motor Sales, Inc., had been divided into two sections for the service of passenger cars and trucks. Passenger cars were repaired in the back end and on the roof of the main building, while trucks were serviced in a reconstructed warehouse in the rear. Under the enthusiastic supervision of Fred Hill, the truck repair volume frequently equaled the service sales on passenger cars. The facility met a growing demand from the owners of light and medium trucks, such as farmers and merchants. Mr. Hill had talked recently with Mr. English about a contract service plan he had devised, which he thought could be made so attractive that many fleet owners would close their own shops. The per hour labor charge would need to be lowered, but the increased volume of parts sales and the contribution to overhead would justify the program.

Mr. Ellis, of the passenger car service division, was working on plans to reduce the costs of his department. With the exception of major jobs, it was almost impossible to schedule customer work. This created fluctuations in the shop which were exasperating to the foreman, and gave large variations in the take-home pay of the mechanics. Mr. Ellis believed that the establishment of a pickup and delivery service for customers might be desirable. He had said that the investment of $1,000 in motorcycle equipment would be justified.

Both Mr. Ellis and Mr. Hill had steadily urged on Mr. English the need for a body and paint shop. Body work was being turned away or subcontracted, although the demand for such work was growing steadily. The paint shop was a bottleneck at current volumes, and unhealthful conditions existed. The paint shop could be made adequate without using greater floor area, but major alterations would be needed. There was no room for a body shop in existing buildings. In fact, light service work was done out of doors whenever the weather permitted.

The personnel in the service department had a high experience level of service with the company. The 14 mechanics and helpers had an average of 11 years' service with the firm. Mr. Ellis had been in charge for 15 years. Mr. Hill, a newcomer, joined the firm in 1946.

Mr. Campbell knew that Mr. English had done some thinking about how to protect the service employees if demand should shrink rapidly. Other firms used loss-leader promotions, package overhauls, etc., which Mr. English thought might introduce some elasticity into the demand, if occasion warranted.

From past executive conferences, Mr. Campbell had learned that the prospects for sales of parts and accessories indicated continued high levels. Older cars were not being retired as fast as new cars were being produced, and the prewar cars had reached ages at which minor replacements were frequent.

The English company had increased its sales of parts and accessories faster than most dealers. Mr. English had established the policy of carrying complete stocks, with the inventory averaging over $100,000 in recent years. Thus Mr. Grant, the department manager, was able to service other dealers and garages who were without parts. Mr. English felt that the prestige built by this service was a source of sales in other departments as well as in the parts department.

Early in 1948, the "Partsmobile," a truck with stock in bins, had been put on the road to sell genuine Chevrolet parts to independent repairmen within a 75-mile radius. By September, Mr. Walter James, the salesman-driver, had added about 150 accounts and $80,000 to the sales volume. When the mobile selling unit was inaugurated in February, Mr. James had had eight competitors. By September, all but one had gone out of business. Mr. Grant was considering adding another Partsmobile as well as a light truck for "hurry-up" orders.

In 1948, Mr. Grant's department employed five people in addition to Mr. Grant and Mr. James. The inventory was stored in the most modern bins, but its bulk had outgrown the space near the shop where operations had begun in 1928. Two-thirds of the display floor, a temporary shed on half of the roof, another shed on the used car lot, and miscellaneous spaces were crowded with stock. This condition not only slowed service but led to easy pilferage and some deterioration.

The cost of stock had risen several times since prewar years. Mr. Grant had been able to anticipate several major price rises, so that there was considerable unrealized profit in the inventory.

In connection with the general overhead expenses in the English company, which were chiefly for rent and salaries, Mr. Campbell knew that the rent was unlikely to change more than any increase in costs because the building was owned by Messrs. English and Herring. When he had talked with Mr. Campbell about taking the job of treasurer, Mr. English had said that he expected to talk soon with the salaried personnel. He thought that the cost of living problem could best be met by a bonus scheme, based on a schedule of percentages of departmental gross margins.

The first dividend by the company, $9,000, had been paid in 1948.

As he considered the above facts about English Motor Sales, Inc., Mr. Campbell had noted a number of trends, or possible policies, which had a bearing upon the supply and use of cash funds. In order further to specify to himself what his new job included, Mr. Campbell began

Exhibit 1

ENGLISH MOTOR SALES, INC.

PRO FORMA BALANCE SHEET, ESTIMATED FOR DECEMBER 31, 1948

ASSETS

	Dollars	Per Cent
Current assets:		
Cash	34,650	10.9
Receivables, time paper	55,000	17.3
Inventories:		
11 new cars	13,750	4.3
3 used and repossessed cars	1,800	0.6
Parts and accessories	100,000	31.5
Supplies	1,200	0.4
U.S. Treasury bonds	77,300	24.3
Prepaid expenses	1,400	0.4
Total current assets	285,100	89.7
Fixed assets:		
Furniture, machinery, etc., after deduction of estimated depreciation	30,300	9.5
Deferred expenses	800	0.3
Other assets	1,700	0.5
Total assets	317,900	100.0

LIABILITIES AND CAPITAL

	Dollars	Per Cent
Current liabilities:		
Accounts payable	30,000	9.4
Accrued local and federal taxes	40,000	12.6
Total current liabilities	70,000	22.0
Capital:		
Capital stock, 300 shares	30,000	9.4
Surplus	217,900	68.5
Total capital	247,900	78.0
Total liabilities and capital	317,900	100.0

to list the additional information which he would like to collect in order that he could keep in touch with developments from a treasurer's point of view. He still felt that the large amount of cash funds that would be on hand in December was probably excessive, but he wanted to be sure that he had overlooked no important possibility affecting the amount actually needed by the business.

Exhibit 2

ENGLISH MOTOR SALES, INC.

PRO FORMA STATEMENT OF ESTIMATED INCOME AND EXPENSE, YEAR 1948

	New Car	*Used Car*	*Service*	*Parts, Etc.*	*Administrative*	*Total*
Number of cars sold	432	36				
Net sales	$636,000	$26,400	$132,000	$348,000	......	
Cost of sales	488,400	21,600	75,600	264,000	......	
Gross profit	$147,600	$ 4,800	$ 56,400	$ 84,000	......	$292,800
Expenses:						
Variable selling expense:						
Salesmen	None	None	None	None	......	
Delivery, advertising, etc.	14,520	960	3,600	......	......	
Total	$ 14,520	$ 960	$ 3,600	......	......	$ 19,080
Semifixed overhead:						
Supervisory salaries	4,500	4,500	9,600	$ 4,800	$13,200	
Salaries and wages	3,600	.....	7,200	19,200	15,000	
Office supplies, etc.	......	.....	......	......	6,420	
Other supplies	......	.....	7,200	300	.....	
Demonstration and company car	300	120	1,200	1,800	2,400	
Freight, etc.	......	.....	......	1,800	.....	
Travel, entertainment	......	.....	......	......	4,500	
Advertising	1,200	.....	1,800	1,800	1,200	
Other	......	.....	......	......	2,400	
Total	$ 9,600	$ 4,620	$ 27,000	$ 29,700	$45,120	$116,040
Fixed overhead:						
Rent	3,900	4,500	5,400	4,500	.....	
Maintenance	......	.....	......	......	7,680	
Insurance	......	.....	......	......	3,600	
Power	......	.....	......	......	2,400	
Taxes	......	.....	......	......	4,800	
Depreciation	......	.....	2,400	3,000	.....	
	$ 3,900	$ 4,500	$ 7,800	$ 7,500	$18,480	$ 42,180
Total expenses	$ 28,020	$10,080	$ 38,400	$ 37,200	$63,600	
Administrative expenses allocated	$ 13,200	$ 3,600	$ 26,400	$ 20,400	.....	$177,300
Total expenses restated	41,220	13,680	64,800	57,600	.....	
Operating profit or (loss)	106,380	(8,880)	(8,400)	26,400		$115,500
Bonuses						$ 25,500
Income taxes						33,360
Dividends						9,000
						$ 67,860

Megaphytic Products Company

In November, 1948, Mr. R. L. Hughson, president and treasurer of the Megaphytic Products Company, was reviewing the operations of the company over the past two years in preparation for a forthcoming visit at the company's bank. In the late fall after he received the auditor's report, it was Mr. Hughson's custom to pay an annual visit to the bank, located in a city some distance from the plant, to discuss with loaning officers the company's plans for the coming year and to make general arrangements to borrow the funds needed to finance the anticipated operations during the year. In preparing for the 1948 trip, Mr. Hughson hoped to determine from a consideration of the operations of the past two years whether a similar pattern of borrowing was probable for the forthcoming season.

The Megaphytic Products Company was a well-known manufacturer and distributor of fertilizers and insecticides in a four-state area. Although it had been incorporated in 1858, its common stock was closely held by members of a few families. Its plant and main offices were located in the small community where it had been founded.

Although production was carried on at a fairly constant rate through the year, sales of the products were concentrated in the spring months.

In recent years, sales of fertilizer had accounted for about 70% of the company's volume. Like most manufacturers of fertilizer the company purchased the basic ingredients in bulk from major chemical concerns. It mixed these ingredients, chiefly superphosphate, potash, and sulphate of ammonia, according to various formulas and bagged the mixture in 100-pound bags. Since the manufacturing operation was a simple one, not more than 15 men were employed for direct labor and the plant payroll amounted to about $35,000 per year. Raw material composed well over half the cost of the fertilizer; plant overhead, selling and administrative expense about one-quarter of the cost.

Certain conditions of availability of the basic raw materials made year-round production of fertilizer necessary. Relatively short supplies of some of these materials in recent years had enabled suppliers to insist on purchase contracts which called for monthly deliveries. Some price concessions, however, were made under such contracts. Thus, potash, which constituted about 12% of the company's fertilizer, had to be contracted for by July 1 of each year for delivery over the following nine months in order to secure a 12% discount. If an order was placed after July 1, but before October 1, a 5% discount was granted. Supplies of this chemical for April, May, and June were purchased as needed during these months on a "net" basis.

Superphosphate, which made up 30% of the fertilizer, presented another problem. The company's supply came largely from Florida and was shipped to it by barge up the Atlantic coast and up the Hudson River. Upper river conditions were suitable for river shipping only during the months from July to December. Since land shipment of this bulky raw material was prohibitively expensive, the entire year's needs of superphosphate were accumulated between July and December.

In the case of all the basic raw materials for fertilizer, trade custom dictated cash payment on delivery. Purchase terms and other details of the major raw material ingredients are given in Table 1.

In 1945 the company added a line of insecticides and miscellaneous garden tools to its product lines. In the case of these lines the company acted essentially as distributor, buying most of the goods in finished form. Up to December, 1948, as an aid in financing the purchase and sale of the insecticides, the company's suppliers gave winter and spring shipments a dating of May 1 with terms of "1% 10 days, net 30" from the May 1 date. However, after December, 1948, terms were to be "net 30." Purchases would then be made about 45 days ahead of need.

The company averaged about a 10% markup on insecticides, although on some items the markup was much lower. Typically, the overall gross margin became smaller as the selling season advanced, since insecticides composed a larger share of the sales.

The company sold through retail outlets, such as grain and hardware stores, and directly to larger farmers in four states. Several salesmen on a salary and commission basis solicited orders from some 2,550 accounts, divided about equally between the farmers and retailers. Farmers took on the average about 15 tons, or $800 worth of fertilizer a year, yet the largest account, that of a farmer, amounted to $8,000.

The salesmen commenced to list fertilizer orders in November, but few shipments were made until January and February. March, with 25% of sales, and April and May, each with 30% of sales, were the months of peak shipment; by May 31 the fertilizer selling season was virtually over, leaving only 15% of sales scattered evenly over the rest of the fiscal year.

One of the objectives in adding the lines in 1945 was to reduce the seasonality in the company's sales. The insecticides and tools were sold in large volume during May and June, each 30% of sales, with 20% of sales throughout the summer, ending about October 1. The first three months of the year accounted for the balance of sales.

Table 1

PURCHASES OF RAW MATERIAL FOR FERTILIZER

Raw Material	Per Cent of Total by Weight	Time of Order	Time of Delivery	Terms
Superphosphate	32	June for year	July to Dec. 1	Net cash on arrival
Sulphate of ammonia	19	June for year	Equal monthly	Net cash on arrival
Muriate of potash	12	June and April	Equal monthly	Net cash on arrival
Castor pomace	7	½ June, ½ Nov. or Dec.	Monthly scattered	Sight draft on arrival
Nitrogen solution	5	June for year	Equal monthly	Net cash on arrival
Nitrate of soda	3	June for year	Depends on arrival from South America; (usually Dec. and May)	Net cash on arrival
Bone	2	Between July and Oct.	As needed	Net cash on arrival
Ammonium nitrate	1	Between July and Oct.	As needed	Net cash on arrival
Uramon	1	Between July and Oct.	As needed	Net cash on arrival
Miscellaneous	18	Between July and Oct.	As needed	Net cash on arrival
	100			

As an incentive to prompt payment by customers, the company offered substantial prompt payment discounts on fertilizer. Although sales were billed "net October 1," by which time the farmers would generally have marketed their crops, discounts of 12% were offered for payment within 10 days of delivery to the customer. Smaller discounts were offered for less prompt payment after delivery. For example, pay-

ment before July entitled the customer to a discount of 3% and before August to 2%. Interest at the rate of 6% per annum was charged on all accounts owing after October 1.

During depression years only about 60% of the customers took advantage of the full 12% discount. Mr. Hughson recalled that at one time his predecessor had said that in the 1920's "the company made more money in the banking business than in the fertilizer business." In recent years, however, about 80% of the customers took the maximum discount. In addition to the prompt payment discounts, the company offered moderate discounts on large orders.

Over the years the company had attempted to encourage its customers to accept early delivery. For example, the company offered to pay the costs of insuring the fertilizer while it was stored in the farmers' barns. Efforts in this direction had done little, however, to change the seasonal pattern of its sales.

Table 2

TIME AND TERMS OF SALE

Product	Per Cent of Dollar Sales	Time of Order	Time of Delivery	Terms
Fertilizer..............	70	Nov.–Feb.	Jan.–May	12% 10 days, net Oct. 1
Insecticides and miscellaneous.............	30	April–July	May–Sept.	1% 10 days, net 30

Terms on insecticides up to December, 1948, were "1% 10 days, net 30," the same as received from the suppliers. However, when the terms became "net 30" after December 31, 1948, Mr. Hughson planned to change his selling terms accordingly. A summary of the terms of sale, time of order, and delivery for the company's products is given in Table 2.

Strenuous efforts were made to keep bad debt losses at a minimum. In forming an opinion on whether to accept particular credit risks, Mr. Hughson relied primarily on the information in reports from credit agencies, although he had found the information in some of the reports quite incorrect.

The company had done business with the Stuyvesant National Bank in a large city for many years, both as a depositor and a borrower. The relationship had been a cordial one, and the company had been able to secure the funds it needed to borrow.

On the basis of an annual discussion of the position and plans of the company, an informal understanding was reached as to the probable needs of the company during the next year. The yearly audited statements, showing the September 30 balance sheet and the annual income statement, as shown in Exhibits 1 and 4, were taken to the bank by Mr. Hughson at the time of this discussion. Although interim statements, such as those in Exhibits 1, 2, and 3 were prepared for the management, the bank had never asked to see them.

In the absence of unusual developments during the year, Mr. Hughson had little direct contact with the bank. Mr. Hughson attempted to maintain a deposit balance of at least $8,000. When the balance declined near this figure, Mr. Hughson talked with his superintendent and reviewed the amount of material scheduled to arrive at the plant during the next three weeks. From the information secured, he determined the amount, if any, to be borrowed from the bank to keep the balance at the desired level. If money were needed, he drew up a note (or notes), usually in $5,000 or $10,000 amounts, for three months, signed it for the company, and forwarded it to the bank. As long as total borrowings were within the limits established in the annual discussions, the bank accepted the note in routine and credited the company's account for the face amount less interest for three months.

For some years, the bank had charged the very low rate of $1\frac{3}{4}\%$ per annum, but in 1947 the rate was raised to 2%. In 1948 the bank advised that its new rate would be $2\frac{1}{2}\%$. Mr. Hughson protested this action, and as a result the bank agreed to "split the difference" and charged $2\frac{1}{4}\%$.

The company had $53,000 United States $2\frac{1}{2}\%$ bonds, which it had carried for a number of years. At one time, Mr. Hughson raised the question with Mr. Burns Williams, a loan officer of the Stuyvesant National, whether these should be sold and borrowings correspondingly reduced. Mr. Williams advised against disposing of the bonds, pointing out that the company received more interest on them than it paid the bank for money borrowed.

It had usually proved necessary to begin borrowing from the bank in October and November, and borrowings generally reached a peak in February. In 1946 borrowing began in November. Repayment began in March and was completed in May. In 1947 borrowing commenced in October, reached a peak in March, and again ended in May.

Exhibit 1

MEGAPHYTIC PRODUCTS COMPANY

QUARTERLY BALANCE SHEET

(Dollar figures in thousands)

	*Sept. 30 1946**	*Dec. 31 1946*	*Mar. 31 1947*	*June 30 1947*	*Sept. 30 1947**	*Dec. 31 1947*	*Mar. 31 1948*	*June 30 1948*	*Sept. 30 1948**
Current assets:									
Cash	$ 46.3	$ 14.8	$ 80.7	$187.6	$ 20.5	$ 19.0	$ 10.0	$ 69.2	$ 29.2
U.S. bonds	53.0	53.0	53.0	53.0	53.0	53.0	53.0	53.0	53.0
Receivables—net	106.4	23.1	209.1	240.1	122.6	36.3	206.2	332.2	163.3
Merchandise inventory	364.8	572.1	502.5	254.3	451.9	616.3	624.8	258.0	393.9
Miscellaneous current	2.9	2.4	2.4	2.3	2.9	2.3	2.3	2.3	3.0
Total current assets	$573.4	$665.4	$ 847.7	$737.4	$650.9	$726.9	$ 896.3	$714.7	$642.4
Fixed assets—net	188.3	204.4	232.1	229.8	235.1	236.4	229.8	221.7	219.2
Other assets	8.2	5.6	7.5	5.6	4.9	7.7	6.5	5.8	6.0
Total assets	$769.9	$875.4	$1,087.3	$972.8	$890.9	$971.0	$1,132.6	$942.2	$867.6
Current liabilities:									
Notes payable—bank	....	$150.0	$ 225.0	....	....	$190.0	$ 275.0	....	....
Accounts payable	$ 6.8	0.4	33.9	$ 5.4	$ 11.7	1.5	30.6	$ 3.3	$ 6.2
Accrued payroll	14.8	0.6	1.3	1.2	42.3	....	1.9	1.6	11.9
Accrued federal income tax	38.5	32.6	32.6	20.9	12.4	42.6	28.4	14.2	....
Other accruals	9.3	10.6	11.2	3.8	7.8	7.9	14.2	3.4	9.8
Reserve for extra compensation	....	5.0	10.1	15.2	....	4.5	9.0	13.5	....
Total current liabilities	$ 69.4	$199.2	$ 314.1	$ 46.5	$ 74.2	$246.5	$ 359.1	$ 36.0	$ 27.9
Capital stock—net	432.5	432.5	432.5	432.5	432.5	441.0	441.0	441.0	441.0
Surplus	268.0	243.7	340.7	493.8	384.2	283.5	332.5	465.2	398.7
Total liabilities	$769.9	$875.4	$1,087.3	$972.8	$890.9	$971.0	$1,132.6	$942.2	$867.6
Net working capital	$504.0	$466.2	$ 533.6	$690.9	$576.7	$480.4	$ 537.2	$678.7	$614.5

* Audited balance sheet.

Exhibit 2

MEGAPHYTIC PRODUCTS COMPANY

QUARTERLY INCOME STATEMENT FISCAL YEARS 1947–1948

(Dollar figures in thousands)

Quarter ending:	*Dec. 31 1946*	*Mar. 31 1947*	*June 30 1947*	*Sept. 30 1947*	*Dec. 31 1947*	*Mar. 31 1948*	*June 30 1948*	*Sept. 30 1948*
Sales:								
Fertilizer	$163.9	$492.1	$ 707.6	$59.8	$110.4	$435.1	$ 893.7	$105.2
Insecticides	11.2	51.8	257.2	105.7	12.3	62.5	348.0	126.3
Miscellaneous	14.0	57.9	44.4	9.4	7.4	21.7	79.1	9.8
Total sales	$189.1	$601.8	$1,009.2	$174.9	$130.1	$519.3	$1,320.8	$241.3
Cost of sales:								
Purchases	319.3	261.5	361.8	333.1	249.7	317.5	537.9	295.9
Inventory increase or (decrease)	207.3	(69.6)	(248.1)	197.4	164.5	8.5	(366.8)	135.8
Inventory used	$112.0	$331.1	$ 609.9	$135.7	$ 85.2	$309.0	$ 904.7	$160.1
Direct labor	11.1	11.8	12.2	7.8	7.1	7.6	11.8	6.5
Other plant expense	56.5	84.1	100.7	100.6	57.5	87.0	117.7	85.6
Cost of goods sold	$179.6	$427.0	$ 722.8	$244.1	$149.8	$403.6	$1,034.2	$252.2
Gross profit or (loss)	$ 9.5	$174.8	$ 286.4	($ 69.2)	($ 19.7)	$115.7	$ 286.6	($ 10.9)

Selling expense:								
Quantity discount	0.3	3.8	9.7	2.8	0.2	4.5	13.5	2.8
Cash discount	8.4	29.1	72.1	11.6	5.0	17.9	86.8	19.4
Salesmen's salaries	9.7	9.7	9.8	9.7	10.5	10.9	10.5	10.5
Other selling expense	7.8	29.6	35.3	5.6	4.5	24.6	40.4	6.6
Total selling expense	$ 26.2	$ 72.2	$ 126.9	$ 29.7	$ 20.2	$ 57.9	$ 151.2	$ 39.3
Operational profit or (loss)	(16.7)	102.6	159.5	(98.9)	(39.9)	57.8	135.4	(50.2)
Other income:								
Recovery of bad debts	0.3	0.6	0.1	0.2	0.1	....	0.2	....
Cash discount received	0.6	0.9	5.2	0.8	0.8	0.9	4.9	0.9
Miscellaneous	2.2	3.7	2.8	4.8	7.6	1.9	2.6	1.7
Total other income	$ 3.1	$ 5.2	$ 8.1	$ 5.8	$ 8.5	$ 2.8	$ 7.7	$ 2.6
	($ 13.6)	$107.8	$ 167.6	($ 93.1)	($ 31.4)	$ 60.6	$ 143.1	($ 47.6)
Other expense	4.1	4.4	3.7	3.9	4.5	5.0	3.9	4.0
Profit or (loss) before taxes	($ 17.7)	$103.4	$ 163.9	($ 97.0)	($ 35.8)	$ 55.6	$ 139.2	($ 51.6)
Profit for year				$152.6				$107.4
Provision for federal income taxes				56.8*				39.9†
Net profit for year				$ 95.8				$ 67.5
Dividends paid during year				36.4				34.6
To surplus				$ 59.4				$ 32.9

* Charged in December, 1947.
† Charged in December, 1948.

In November, 1948, after Mr. Hughson received the auditor's report he began to consider the company's needs for the 1949 season. He expected sales to be about the same as in 1948 or perhaps a little less. This was because the government farm price support program required that the potato acreage be cut 20%. As the potato growers took about 20% of the fertilizer tonnage, Mr. Hughson felt that the company might experience a drop in sales to these producers.

Most of the salesmen reported that the farmers were holding back on their orders. Evidently they planned to wait until the last moment before they committed themselves. Mr. Hughson felt that, unless economic conditions deteriorated greatly, the farmers would still buy in the long run about as much fertilizer and insecticides as they had been accustomed to buying. However, the fact of the farmers' holding back until the very last would cause Megaphytic to store the inventory for a longer period.

Exhibit 3

MEGAPHYTIC PRODUCTS COMPANY

INVENTORY DETAIL

Quarterly, December 31, 1947 to September 30, 1948

(Dollar figures in thousands)

	Dec. 31 1947	*Mar. 31 1948*	*June 30 1948*	*Sept. 30 1948*
Fertilizer:				
Raw material	$218.5	$251.3	$106.7	$204.7
In process	270.9	155.8	13.7	97.3
Finished goods	13.9	73.0	10.2	6.3
Insecticides:				
Raw material	62.0	84.2	86.5	64.2
Finished goods	0.5	1.1	5.0	1.4
Packaging	1.5	1.2	2.1	0.4
Containers	34.5	44.3	25.2	14.8
Miscellaneous	14.5	13.9	8.6	4.8
Total inventory	$616.3	$624.8	$258.0	$393.9

Exhibit 4

MEGAPHYTIC PRODUCTS COMPANY

INCOME STATEMENT FOR FISCAL YEAR 1948

(Dollar figures in thousands)

Gross sales:			
Fertilizers	$1,544		
Insecticides	549		
Miscellaneous	118		
Total sales		$2,211	
Less: Sales discounts	$ 129		
Quantity discounts	21		
Commissions	4		
Consignment account expense	60	214	
Net sales			$1,997
Cost of sales:			
Inventory—beginning of year	$ 452		
Purchases	1,401		
Total		$1,853	
Less: Inventory—end of year		394	
Material consumed in sales		$1,459	
Direct labor		33	
Manufacturing expense*		103	
Total cost of sales			1,595
Gross profit on sales			$ 402
Selling expenses:			
Freight and trucking		$ 105	
Selling and shipping		114	
Total selling expenses			219
			$ 183
Administrative expense*			84
Operating profit			$ 99
Other income:			
Discounts on purchases		$ 7	
Interest received		3	
Rents received		2	
Recoveries of bad debts		1	
Sale of scrap and miscellaneous		6	
Profit on assets sold		5	24
Total other income			$ 123
Other deductions:			
Interest paid		$ 2	
Pensions paid		3	
Contribution to pension trust		12	17
Net income for year			$ 106
Provision for federal income tax			40
Net profit for year			$ 66

* Includes $20, depreciation.

Clarkson Lumber Company

Following a rapid growth in its business during recent years, the Clarkson Lumber Company in the spring of 1940 anticipated a further substantial increase in sales. Despite good profits, which were largely retained in the business, the company had experienced a shortage of cash and had found it necessary to borrow $48,000 from the Suburban National Bank. In the spring of 1940, additional borrowing seemed necessary if sales were to be increased and purchase discounts taken. Since $48,000 was the maximum amount which the Suburban National would lend to any borrower, it was necessary for Mr. Paul Clarkson, proprietor of the Clarkson Lumber Company, to look elsewhere for additional credit.

Through a personal friend who was well acquainted with one of the officers of a large metropolitan bank, the Northrup National Bank, Mr. Clarkson obtained an introduction to the officer and presented a request for an additional bank loan of $80,000. Consequently, the credit department of the Northrup National Bank made its usual investigation of the company for the information of the loan officers of the bank.

The Clarkson Lumber Company was founded in 1930 as a partnership of Mr. Clarkson and Mr. Henry Stark, a brother-in-law of Mr. Clarkson. Six years later Mr. Clarkson bought out Mr. Stark's interest and continued the business as sole proprietor.

The business was located in a suburb of a large midwestern city. Land and a siding were leased from a railroad. Two portable sheet metal storage buildings had been erected by the company. Operations were limited to the wholesale distribution of plywood, moldings, and sash and door products to lumber dealers in the local area. Credit terms of net 30 days and net 60 days on open account were usually offered customers.

Sales volume had been built up largely on the basis of successful price competition made possible through careful control of operating expenses and by quantity purchases of materials at substantial discounts. Almost all of the moldings and sash and door products, which amounted to 40% and 20% of sales, respectively, were used for repair work. About 55% of total sales were made in the six months from March through August. No sales representatives were employed, orders being taken exclusively over the telephone. Annual sales of $313,646 in 1935 and of $476,275 in 1936 gave net profits of $32,494 and of $34,131, respectively. Comparative operating statements for the years 1937 through 1939 and for the three months ending March 31, 1940, are given in Exhibit 1.

Mr. Clarkson was an energetic man, 39 years of age, who worked long hours on the job, not only handling management matters but also performing a large amount of the clerical work. Help was afforded by an assistant who, in the words of the investigator of the Northrup National Bank, "has been doing and can do about everything that Mr. Clarkson does in the organization."

Other employees numbered 14, of whom 11 worked in the yard and 3 drove trucks. Mr. Clarkson had adopted the practice of paying union dues and all social security taxes for his employees; in addition, bonuses were distributed to them at the end of each year. In 1939 the bonus amounted to 40% of annual wages. Mr. Clarkson was planning to incorporate the business in the near future and to sell stock to certain employees.

As a part of its customary investigation of prospective borrowers, the Northrup National Bank sent inquiries concerning Mr. Clarkson to a number of firms which had business dealings with him. The manager of one of his large suppliers, the Barker Company, wrote in answer:

> The conservative operation of his business appeals to us. He has not wasted his money in disproportionate plant investment. His operating expenses are as low as they could possibly be. He has personal control over every feature of his business and he possesses sound judgment and a willingness to work harder than anyone I have ever known. This with a good personality, gives him an excellent turnover and from my personal experience in watching him work, I know that he keeps close check on his own credits.

All of the other trade letters received by the bank bore out the statements quoted above.

In addition to the ownership of his lumber business, Mr. Clarkson

Exhibit 1

CLARKSON LUMBER COMPANY

OPERATING STATEMENTS FOR THE YEARS ENDING DECEMBER 31, 1937, THROUGH 1939 AND FOR THE THREE MONTHS ENDING MARCH 31, 1940

(Dollar figures in thousands)

	1937	*1938*	*1939*	*1st Quarter 1940*
Net sales	$740	$880	$1,179	$310*
Cost of goods sold:				
Beginning inventory	111	97	141	180
Purchases	611	846	1,069	336
	$722	$943	$1,210	$516
Ending inventory	97	141	180	244
Cost of goods sold	$625	$802	$1,030	$272
Gross profit	$115	$ 78	$ 149	$ 38
Operating expenses	38	48	73	20
Net operating profit	$ 77	$ 30	$ 76	$ 18
Add: Purchase discounts taken	5	5	5	0.6
	$ 82	$ 35	$ 81	$ 19
Deduct: Sales discounts allowed	16	18	28	8
Net profit†	$ 66	$ 17	$ 53	$ 11*
Drawings by proprietor	...	...	$ 28	$ 6

* In the first quarter of 1939, net sales were $252,000 and net profit was $13,000.

† This item is stated before any provision for federal income tax liabilities. As distinct from corporations, no federal income taxes are levied on the profits of proprietorships and partnerships, as such. The owners of a proprietorship or partnership, however, must include in their personal income their proportionate share of such profits and must pay taxes on them at the regular personal income tax rates.

Exhibit 2

CLARKSON LUMBER COMPANY

Comparative Balance Sheets as of December 31, 1937, through 1939, and as of March 31, 1949

ASSETS	1937	1938	1939	March 31 1940
Cash	$ 56	$ 282	$ 3,560	$ 1,338
Accounts receivable—net of reserve for bad debts	57,322	89,387	109,686	128,893
Inventory	97,005	141,416	179,557	243,658
Total current assets	$154,383	$231,085	$292,803	$373,889
Property—net of reserve for depreciation	5,963	7,608	11,430	10,361
Deferred charges	......	......	......	2,594
Total assets	$160,346	$238,693	$304,233	$386,844
LIABILITIES				
Notes payable—bank	......	......	......	$ 48,000
Notes payable—employees for bonuses	......	......	......	4,840
Notes payable—Henry Stark	$ 32,000	......	......	......
Notes payable—trade	......	......	......	65,767
Accounts payable	57,460	$136,723	$173,439	138,336
Accrued expenses	......	3,440	7,194	902
Total current liabilities	$ 89,460	$140,163	$180,633	$257,845
Net worth	70,886	98,530	123,600	128,999
Total liabilities	$160,346	$238,693	$304,233	$386,844

held jointly with his wife an equity in their home, which was mortgaged for $12,000 and which cost $20,160 to build in 1927. He also held a $16,000 life insurance policy, payable to Mrs. Clarkson. Mrs. Clarkson owned independently a half-interest in a home worth about $8,000.

The bank gave particular attention to the debt position and current ratio of the business. It noted the ready market for the company's products at all times and the fact that sales prospects were particularly favorable. The bank's investigator reported: ". . . it is estimated sales may run from $1,280,000 to $1,600,000 in 1940." The rate of inventory turnover was high, and losses on bad debts in past years had been quite small. Comparative balance sheets as of December 31, 1937, through 1939 and as of March 31, 1940, are given in Exhibit 2 (p. 31).

The bank learned, through inquiry of another wholesale lumber company, that the usual terms of purchase in the trade were 2%, 10 days after arrival. Suppliers took 60-day notes when requested but did this somewhat unwillingly.

Tremblant Manufacturing Company

In October, 1947, Mr. James T. Hill, treasurer of the Tremblant Manufacturing Company, requested an additional loan of $150,000 from the Idlewild National Bank in order to make a rearrangement of production facilities for laborsaving and greater economy in operation. This was in addition to a loan of $350,000 for new plant equipment and working capital which the bank had made in July, 1947.

The Tremblant Manufacturing Company fabricated aluminum novelty items, such as curlers, small trays, small boxes, etc., for the chain-store trade and larger aluminum trays for the restaurant industry. During 1945 the company embarked on a program to roll aluminum foil with colored patterns and designs embossed or printed thereon. This product was to be used for packaging, and it met with an enthusiastic market.

The bank's files on the company indicated that it had commenced business in 1929 with a small capital investment. A group of small factory buildings had been purchased in Cincinnati, Ohio, at a nominal figure, but considerable amounts had been spent from time to time in renovating them. Operations at first were relatively simple but became more complex as conditions changed, especially with the advent of the war. Late in the war the company entered the aluminum foil business.

Before the war this type of foil had been made exclusively in Europe, where the processes were secret. However, the president of the company, Mr. A. N. Trembley, through connections in France had learned a little of the general nature of the technique, which, when coupled with methods of treating aluminum developed in the United States during the war, enabled the company to evolve a technique for embossing and coloring aluminum foil during the rolling operations.

The Idlewild National Bank had received from time to time favorable reports regarding the company and its personnel from other banks,

from suppliers of Tremblant, and from credit agencies. Mr. Trembley was described as ". . . one of the ablest men in the business. He has been very successful and is a hard competitor." Another source described the concern as ". . . a wonderful outfit. They are very aggressive, very capable, and have made a pronounced success of their business. James Hill, the treasurer, has his feet solidly on the ground. He watches over the company's affairs with the utmost precision." One source reported a situation some time before the war when Japanese competition seriously threatened the Tremblant company's business. The company soon met this competition by developing methods which enabled it to undersell the Japanese in spite of their lower labor costs.

The Idlewild National Bank learned from credit agencies that the company purchased on 30-day terms. None of its principal suppliers indicated any slowness in payment. The bank did not know what terms the company extended to its customers, although it did know that credit insurance was carried on its accounts receivable.

Mr. Eddy's predecessor as senior loan officer of the bank, after a visit to the plant in Cincinnati on August 10, 1947, made this report:

> They believe that the field for their products at the moment is almost unlimited. The factory appears very neat, and extensive mechanization makes labor a comparatively unimportant factor in costs. The plant is unionized, but they consider their relations with their employees reasonably satisfactory. They employ from 530 to 620 people depending on trade conditions. The greater number of employees seem to be employed in the inspection, packing and shipping departments. They maintain a research laboratory which is, in itself, a small pilot plant. The executives with whom I talked created a favorable impression. They are hard workers, and are keenly interested in the company.

In July, 1947, the company secured a loan from the Idlewild National Bank consisting essentially of two parts:

1. A loan of $270,000 at 4% interest to be repaid in 27 equal monthly payments commencing February, 1948. This loan was to be used to purchase precision rollers and presses. These presses were to be the largest of their kind in the United States and would turn out amounts of foil much in excess of orders on hand. The company felt that it would experience no difficulty in disposing of these large amounts of foil once it could promise reasonable delivery and continuity of supply. The managment indicated at this time that after the completion of this project no further expansion was contemplated for five years at least.

2. A loan of $80,000 for working capital. This loan was a renewal of one of the same amount granted previously and under the new arrangements would mature on July 15, 1948.

In October, 1947, Mr. Trembley and Mr. Hill called on Mr. Frank Eddy, the new senior loan officer of the bank, to explore the possibilities of securing an additional loan of $150,000, which was to be used to make a rearrangement of facilities to effect economies in labor, etc., rather than to obtain increased production. This plan had been planned before and held in abeyance, but the company's line of foils had been so well received that it was felt that it would be advantageous to include this additional expenditure in the present program.

Inasmuch as Mr. Eddy had just recently assumed responsibility for the Tremblant account and was not familiar with the company's past methods of financing and handling of its funds, he felt he should first make a comprehensive study of the financial statements in his files, as shown in Exhibits 1, 2, and 3, and thus be able to discuss with the other officers of the bank the advisability of making this loan.

Exhibit 1

TREMBLANT MANUFACTURING COMPANY

PROFIT AND LOSS STATEMENTS
(Dollar figures in thousands)

	Year 1945	*Year 1946*	*Six Months January 1, 1947–June 30, 1947*
Net sales	$3,461	$5,743	$2,643
Less: Discounts allowed	16	40	15
	$3,445	$5,703	$2,628
Cost of sales	3,035	4,872	2,194
Gross profit	$ 410	$ 831	$ 434
Administrative and selling expense	227	277	133
Operating profit	$ 183	$ 554	$ 301
Sundry income	19	20	11
	$ 202	$ 574	$ 312
Sundry expense	16	32	7
Net profit before taxes	$ 186	$ 542	$ 305
Provision for taxes	94	224	119
Net profit transferred to surplus	$ 92	$ 318	$ 186

Exhibit 2

TREMBLANT MANUFACTURING COMPANY

SELECTED ACCOUNTING DATA

(Dollar figures in thousands)

Year	*Sales*	*Depreciation Charged*	*Profit before Taxes*	*Profit after Taxes*	*Dividends Paid*	*Surplus Adjustments**	*Net Worth End of Year*
1941	$2,480	†	$146	$105	..	..	$ 616
1942	2,187	†	57	37	..	..	629
1943	2,649	†	94	56	..	..	656
1944	3,309	$ 94	232	120	..	$16	786
1945	3,461	102	186	92	..	49	922
1946	5,743	114	542	318	$40	25	1,175
6 months 1947	2,643	70	305	186	..	..	1,361 (6/30/47)

* Charges or refunds relating to taxes of previous years.
† Figures were not available to the bank.

Exhibit 3

TREMBLANT MANUFACTURING COMPANY

BALANCE SHEETS

(Dollar figures in thousands)

ASSETS	Dec. 31 1943	Dec. 31 1944	Dec. 31 1945	Dec. 31 1946	June 30 1947
Current:					
Cash	$ 70	$ 217	$ 221	$ 256	$ 146
Accounts receivable—net	168	152	200	457	383
Inventories	235	181	233	504	497
Total current	$ 473	$ 550	$ 654	$1,217	$1,026
Fixed assets at cost	$ 819	$ 910	$1,106	$1,417	$1,591
Less: Reserve for depreciation	350	424	490	559	595
Net fixed assets	$ 469	$ 486	$ 616	$ 858	$ 996
Advance payments on machinery	....	15	19	29	11
Deferred charges	44	34	13	34	28
Investment in subsidiary	29	34	34	48	48
Advances to stockholders and officers	32	44	49	27	34
Patents, trademarks	7	7	12	12	12
Total assets	$1,054	$1,170	$1,397	$2,225	$2,155
LIABILITIES					
Current:					
Notes payable—bank	$ 35	$ 5	....	....	$ 80
Accounts payable—trade and equipment	244	189	$ 265	$ 588	257
Provision for taxes	68	114	133	282	270
Dividend payable	....	....	....	40	....
Real estate mortgage—current	6	13	13	26	30
Accrued expenses	....	....	18	50	71
Total current	$ 353	$ 321	$ 429	$ 986	$ 708
Real estate mortgage—deferred	45	63	46	64	86
Common stock	171	165	160	160	160
Surplus	485	621	762	1,015	1,201
Total liabilities	$1,054	$1,170	$1,397	$2,225	$2,155

United American Manufacturing Company[1]

Early in March, 1949, the president of the United American Manufacturing Company asked the treasurer of the company, Mr. J. Q. Publican, to prepare a brief talk for presentation at the annual meeting of the stockholders of the company to be held approximately in two weeks. Condensed income statements and balance sheets for each quarter of the last two years, as shown in Exhibits 1 and 2, would be distributed at the stockholders' meeting. The president asked Mr. Publican to prepare to explain in simple terms the present financial condition of the company and to point out any significant changes in the company's financial condition as revealed by either the profit and loss statements or the balance sheet. He emphasized that, since many of the stockholders would not have a very good understanding of financial matters, it was essential that the remarks be accurate but stated in simple language and straightforward terms readily understandable by all persons.

[1] The material in this case is from various published sources.

Exhibit 1

UNITED AMERICAN MANUFACTURING COMPANY

CONDENSED INCOME STATEMENTS

(Rounded to thousands)

INCOME AND EXPENSE	*Jan.–Mar. 1947*	*April–June 1947*	*July–Sept. 1947*	*Oct.–Dec. 1947*	*Jan.–Mar. 1948*	*April–June 1948*	*July–Sept. 1948*	*Oct.–Dec. 1948*
Net sales	$35,383	$36,863	$37,279	$41,167	$39,963	$40,772	$42,053	$42,844
Costs and expenses	31,034	32,830	33,404	37,031	35,365	36,282	37,445	38,247
Net operating profit	$ 4,349	$ 4,034	$ 3,875	$ 4,135	$ 4,598	$ 4,490	$ 4,608	$ 4,597
Other income or deductions—net	28	45	74	43	16	31	5	60
Net income before federal income taxes	$ 4,377	$ 4,078	$ 3,949	$ 4,178	$ 4,614	$ 4,521	$ 4,613	$ 4,657
Provision for federal income taxes	1,713	1,587	1,526	1,624	1,749	1,676	1,705	1,731
Net income after federal income taxes	$ 2,664	$ 2,492	$ 2,423	$ 2,554	$ 2,865	$ 2,845	$ 2,907	$ 2,925
Dividends paid	722	816	799	1,381	849	929	981	1,587

Exhibit 2

UNITED AMERICAN MANUFACTURING COMPANY

CONDENSED BALANCE SHEETS

(Rounded to thousands)

ASSETS	*Mar. 31 1947*	*June 30 1947*	*Sept. 30 1947*	*Dec. 31 1947*	*Mar. 31 1948*	*June 30 1948*	*Sept. 30 1948*	*Dec. 31 1948*
Cash	$10,113	$11,322	$11,461	$11,179	$ 11,132	$ 11,213	$ 11,337	$ 10,969
U.S. government securities	6,688	6,286	6,394	6,840	6,690	6,623	6,974	7,077
Accounts and notes receivable—net	11,655	11,395	12,192	12,110	12,911	12,885	13,915	12,909
Inventories	24,726	25,224	25,517	26,473	27,582	28,039	28,881	29,722
Other current assets	1,580	1,276	1,331	1,407	1,214	1,284	1,268	1,302
Total current assets	$54,762	$55,503	$56,895	$58,009	$ 59,528	$ 60,045	$ 62,375	$ 61,978
Property, plant and equipment—net	28,496	29,877	31,045	32,321	33,816	35,778	36,907	38,894
Other assets including deferred charges	6,369	6,559	6,694	7,234	6,988	7,349	7,382	7,593
Total assets	$89,627	$91,939	$94,634	$97,564	$100,332	$103,171	$106,665	$108,465
LIABILITIES								
Bank loans payable within one year	$ 2,645	$ 2,272	$ 2,489	$ 2,786	$ 2,737	$ 2,539	$ 2,988	$ 2,957
Other notes and accounts payable	6,781	6,747	6,858	7,716	7,286	7,389	7,675	8,054
Federal income taxes accrued	5,780	6,323	6,707	7,101	7,114	7,198	7,464	7,655
Other current liabilities	4,006	4,181	4,295	4,108	4,347	4,359	4,530	4,325
Total current liabilities	$19,212	$19,523	$20,349	$21,711	$ 21,484	$ 21,485	$ 22,657	$ 22,990
Long-term debt—bank loans	*	*	*	*	2,535	2,734	2,922	3,147
Long-term debt—other	7,649	7,963	8,321	8,751	6,394	6,295	6,523	6,966
Other liabilities	*	*	*	*	904	943	1,048	913
Reserves	†	†	†	†	2,659	2,886	2,953	2,771
Capital stock and capital surplus	62,767	64,454	65,964	67,103	33,098	33,968	34,007	34,467
Earned surplus and surplus reserves	†	†	†	†	33,257	34,860	36,554	37,210
Total liabilities	$89,627	$91,939	$94,634	$97,564	$100,332	$103,171	$106,665	$108,465

* Included under "Long-term debt—other."
† Included under "Capital stock and capital surplus."

Monroe Department Store

In the late spring of 1948, the officers of the Monroe Department Store in Rochester, New York, began to consider the advisability of opening a branch store in Batavia, a city of about 20,000 population, located about 30 miles toward Buffalo. Preliminary investigation indicated that a branch in Batavia might enjoy a sales volume of about $1,000,000 a year.

Local interests had offered space for the branch to the Monroe company, in a new building fully equipped, centrally located, and on satisfactory rental terms.

Early in the consideration of this possibility, the officers took up questions of the financial requirements of the branch and the financial position of the Monroe company with reference to the requirements. After a little discussion it was decided to obtain some estimates to see if the project was within the financial capacity of the company. Accordingly, the controller of the company asked Mr. Arthur Gold, an employee in his department, to study the available information about typical stores and to compute approximate figures. Mr. Gold was told that there were two objectives. The first was to estimate the needed investment in working capital for the branch. The second was to see if this amount of funds could be provided by the Monroe company, without weakening its position to an undesirable extent.

Since no detailed plans for the branch were available, Mr. Gold determined to accumulate information about "typical" stores to guide his calculations. After several hours of search, Mr. Gold had on his desk the material presented in Exhibits 1, 2, and 3. He was satisfied that little more information of the same nature could be collected. In fact, he felt that he had perhaps collected more than he could use.

Exhibit 1

MONROE DEPARTMENT STORE

INTERNAL DATA

(Dollar figures in thousands)

BALANCE SHEET, AT JANUARY 31, 1948

ASSETS

Cash	$ 1,526
U.S. bonds	825
Accounts receivable, net	1,793
Inventory, at cost	2,073
Current assets	$ 6,217
Fixed assets, net	3,074
Deferred charges	67
Other assets	36
	$ 9,394

LIABILITIES

Accounts payable	$ 886
Accrued taxes	903
Current liabilities	$ 1,789
Reserves	856
Common stock	2,900
Earned surplus	3,849
	$ 9,394

EARNINGS, YEAR ENDED JANUARY 31, 1948

Net sales	$15,141
Cost of sales	8,357
Expenses	4.970
Operating profit	$ 1,814
Income from broadcasting station	259
Profit before income tax	$ 2,073
Estimated income taxes	800
Net profit	$ 1,273
Added to reserves	300
Balance	$ 973

OTHER DATA (AS REPORTED TO HARVARD BUREAU) *

Stock turn, based on beginning and ending inventories at cost	4.7
Inventory, end of period, as % net sales	13.7

* See Exhibit 2.

Exhibit 2

MONROE DEPARTMENT STORE

Selected Statistical Data from 1947 Issue of *Operating Results of Department and Specialty Stores* Harvard Bureau of Business Research, 1948

TABLE 4

COMMON FIGURES* FOR MERCHANDISING OPERATIONS AND PROFITS

Annual Sales	Net Sales	Gross Margin	Net Profit	Stock Turn†
$10,000,000–$20,000,000	100.0%	35.6%	4.9%	5.1
1,000,000– 2,000,000	100.0	34.5	6.5	4.9

* A "common figure," by Bureau definition, is a representative result selected for each individual item. It is intended to reflect a typical performance from the stores studied.

† Based on beginning and ending inventories at cost:

$$\frac{\text{Cost of Sales}}{\frac{1}{2}\text{ (Beginning Inv. + Ending Inv.)}}$$

TABLE 11

COMMON FIGURES FOR CREDIT DATA

Annual Sales	Net Sales	Cash	Credit	Average Accounts Receivable, as % Credit Sales for Year
$10,000,000–$20,000,000	100.0%	50.0%	50.0%	20.0%
1,000,000– 2,000,000	100.0	57.0	43.0	15.0

TABLE 14

SUPPLEMENTARY DATA ACCORDING TO SIZE OF CITY

Size of City	Annual Sales	Stock Turn*
250,000–500,000	$10,000,000–$20,000,000	5.1
15,000– 25,000	1,000,000– 2,000,000	5.3

* Based on beginning and ending inventories at cost:

$$\frac{\text{Cost of Sales}}{\frac{1}{2}\text{ (Beginning Inv. + Ending Inv.)}}$$

TABLE 15

OPERATING RESULTS ACCORDING TO FORM APPROVED BY NRDGA

Annual Sales	Net Sales	Inventory		Operating Income
		Beginning	Ending	
$10,000,000–$20,000,000	100.0%	12.1%	13.2%	4.9%
1,000,000– 2,000,000	100.0	13.4	14.0	6.5

Exhibit 2—Continued

TABLE 16

AGGREGATE* WORKING CAPITAL POSITION OF 76 DEPARTMENT STORES WITH SALES OF $10,000,000 OR MORE AT END OF FISCAL YEAR: 1947

Net sales†	100.0%
Total current assets	29.6
Net working capital	19.7
Current assets:	
Cash and government securities‡	17.8%
Accounts receivable	38.9
Merchandise inventories§	42.1
Other	1.2
Total	100.0%
Current assets ÷ Current liabilities	299.1%

* Computed by totaling the dollar figures reported by the several stores.
† Net sales of the 76 stores (owned departments only) amounted to $1,981,344,000 for the fiscal year 1947.
‡ All tax notes have been considered as current assets rather than as deductions from current liabilities.
§ Lower of cost or market, first-in first-out basis.

Exhibit 3

MONROE DEPARTMENT STORE

DEPARTMENT STORE RATIOS PUBLISHED BY DUN & BRADSTREET, INC.*
BASED ON YEAR-END FIGURES FOR 1947

	Unit	*Upper Quartile†*	*Median†*	*Lower Quartile†*	*5-Year Average*
Current assets to current debt	Times	4.50	3.09	2.37	2.80
Net profits to net sales	%	6.82	4.22	2.62	4.17
Net profits to tangible net worth	%	22.80	16.10	9.10	15.04
Net profits to net working capital	%	31.70	22.60	14.65	22.57
Turnover of tangible net worth	Times	4.82	3.86	2.79	3.43
Turnover of net working capital	Times	6.58	5.09	3.60	4.97
Net sales to inventory	Times	8.9	6.9	5.1	7.6
Fixed assets to tangible net worth	%	6.2	17.0	37.2	17.1
Current debt to tangible net worth	%	20.7	32.2	50.6	36.7
Total debt to tangible net worth	%	41.2	57.3	63.3	59.3
Inventory to net working capital	%	46.8	72.4	92.0	63.5
Current debt to inventory	%	43.9	72.6	98.4	91.4
Funded debt to net working capital	%	17.3	28.4	44.4	41.8

* These appear in *Dun's Review*, November, 1948, and in the booklet, "The Theory of Corporate Net Profits." Used here by permission of Dun & Bradstreet, Inc.

† To obtain these figures, the ratios for the stores were arranged in order of size. The median ratio is the one at the middle of this series. The quartiles are the ratios that were halfway between the extremes and the median (or one-quarter of the way from each extreme). In each case the figure used is reached by counting the items, not by averaging the ratios.

Larabee Company

On January 6, 1947, Mr. John Larabee, the owner and manager of a small retail store specializing in children's clothing and accessories, was engaged in preparing a cash budget for the first six months of 1947. The budget was being prepared at the request of Mr. Wilbert Walker, an officer of the Security National Bank, where the Larabee Company maintained a deposit and borrowing account. Mr. Larabee had recently called on Mr. Walker to talk over his plans for the spring season and to make sure that the bank would continue to supply the necessary credit to meet the needs of the company. After reviewing the balance sheet of the company as of January 1, 1947, as shown in Exhibit 1, and discussing Mr. Larabee's expectations as to purchases and sales of merchandise during the next six months, as shown in Exhibit 2, Mr. Walker expressed the opinion that it would be easier to visualize the company's probable needs for credit if Mr. Larabee would draw up a cash budget. In reply to Mr. Larabee's question as to just what he meant by "cash budget," Mr. Walker explained that what he had in mind was a statement of expected cash receipts and payments for each of the next six months. Mr. Larabee agreed to draw up such a statement and to return for further discussion based on the statement.

Mr. Larabee had opened the store in the latter part of 1943. Since his personal capital had been limited, he had been forced to borrow heavily and to limit sales to a cash basis. Sales had expanded rapidly, with corresponding increases in investment in inventory. In 1946, net sales had amounted to $181,800, net profit before federal income taxes $17,158, and net profit after taxes $11,740. Since the store was not incorporated, the net profit was taxed as personal income.

During the first three years of operation, Mr. Larabee had aimed at building a clientele of steady customers who would patronize the store because they expected good quality at a reasonable price and not

primarily because they were attracted by the promotion of special items at exceptionally low prices. As part of this program he eliminated price appeal from all his advertising and emphasized the quality and service to be obtained at Larabee's. His chief competition came from department stores and specialty stores which carried children's wear in addition to other apparel. Since these stores offered charge accounts to their customers, Mr. Larabee had decided that he must offer similar arrangements. Therefore, he decided to make allowance in his cash budget for the probable effect of offering 30-day open charge accounts. He estimated that if he offered 30-day open charge accounts to his customers 5% of his sales would be charge sales in January, 10% in February, 13% in March, 16% in April, 18% in May, and 20% in June. According to department store figures in the *Federal Reserve Bulletin* for December, 1946 (p. 1406), the average ratio of collections during a month to accounts receivable at the beginning of the month had been approximately 60% during the first 10 months of 1946.

The usual terms for Larabee's purchases of merchandise were 8/10 E.O.M.,[1] and such terms could be applied to the $12,600 accounts payable shown on the January 1 balance sheet. The other accounts payable shown on the balance sheet represented various obligations other than the purchase of merchandise and were payable at face value in January. The "Notes payable—bank" were due February 1. The bank had been extending credit on 30-day notes at 6% annual interest and renewing them as necessary. Mr. Larabee expected this practice would be continued.

The social security and withholding taxes of $412 were due in January.

Mr. Larabee had estimated his 1946 income tax at $100 and had paid three quarterly installments of $25 each on March 15, June 15, and September 15, 1946. Another $25 installment was due on January 15. On January 1, 1947, he estimated his final tax for 1946 at $5,418. Therefore the amount payable on March 15 would be $5,418 less $100. Currently, Mr. Larabee estimated his quarterly payments for 1947 income tax at $1,350. Two of these would be paid on March 15 and June 15.

Mr. Larabee's merchandise plans for the spring season had been made on the assumption that all sales would be made for cash. Although he believed that offering charge accounts might bring about a greater

[1] The terms "8/10 E.O.M." meant that an 8% cash discount would be allowed for payment within 10 days after the end of the month in which the invoice was dated.

Exhibit 1

LARABEE COMPANY

BALANCE SHEET

As of January 1, 1947

ASSETS

Current assets:		
Cash	$ 4,930	
Deposits for utilities	105	
Inventory, December 31, 1946, at cost	37,143	
Total current assets		$42,178
Fixed assets:		
Fixtures and equipment	$ 3,268	
Automobile	1,528	
Total fixed assets		4,796
Total assets		$46,974

LIABILITIES

Current liabilities:		
Accounts payable—merchandise, at billed cost	$12,600	
Other accounts payable	820	
Social security and withholding tax	412	
Notes payable—bank	3,750	
Income tax for 1946*	5,343	
Total current liabilities		$22,925
Net worth as of January 1, 1946	$17,033	
Profit for period	11,740	
	$28,773	
Withdrawals	4,724	
Net worth as of January 1, 1947		24,049
Total liabilities		$46,974

* Due March 15, 1947, except for $25 due January 15.

Exhibit 2

LARABEE COMPANY

PLANNED PURCHASES AND SALES OF MERCHANDISE

	Planned Sales	*Planned Purchases at Billed Cost*
January	$ 9,500	$ 3,821
February	12,000	15,925
March	22,000	13,325
April	17,000	9,555
May	17,000	7,020
June	13,500	6,175
	$91,000	$55,821

increase in sales than the 20% planned in the budget, he believed that the magnitude of the increase was so uncertain as to make it unwise to increase his budget. Among the important factors considered in the preparation of the merchandise budget was the fact that Easter fell on April 6 in 1947. Mr. Larabee's contemplated purchases and his estimated sales through June are shown in Exhibit 2.

Since Mr. Larabee had all his money invested in the business, he found it necessary to withdraw cash for his personal use each month. He estimated that these withdrawals would be approximately $350 per month during the first six months of 1947.

Mr. Larabee had made a table of expenditures as shown in Exhibit 3. This budget included certain items calling for cash outlay during the period. Included in the various breakdowns of outlay for January were the amounts shown on the January 1 balance sheet as "Other accounts payable" and "Social security and withholding tax." The expense budget did *not* include anticipated income tax payments, Mr. Larabee's withdrawals, or anticipated payments for merchandise.

In view of the difficulty of estimating accurately the small amount that would be paid the bank as interest, the banker, Mr. Walker, had suggested that the outlay for bank interest not be included in the calculations. Mr. Larabee planned to accept this suggestion. All other foreseeable outlays as indicated would be included.

Exhibit 3

LARABEE COMPANY

PARTIAL CASH DISBURSEMENT BUDGET FOR PERIOD ENDING JUNE 30, 1947

	Jan.	*Feb.*	*Mar.*	*April*	*May*	*June*	*Total*
Payroll	$1,400	$1,600	$2,000	$1,800	$1,800	$1,600	$10,200
Rent	400	400	400	400	400	400	2,400
Advertising	150	400	800	600	600	400	2,950
Supplies	150	200	350	250	200	150	1,300
Other	700	600	800	700	700	500	4,000
Total	$2,800	$3,200	$4,350	$3,750	$3,700	$3,050	$20,850

Linwood Company

Early in April, 1941, the Linwood Company submitted an audited financial statement to the Third National Bank of its city. This statement showed the results of operations for the first three months of the year. It was observed that, despite greatly increased volume of sales due to war orders, the company had lost more heavily in this period than in the year 1940. Figures from the reports covering both periods will be found in Exhibits 1 through 3. Since the bank had already loaned the company $325,000 and anticipated being asked to advance further funds, it was decided to make a further investigation of the situation.

The Linwood Company manufactured a patented air filter for automotive engines. Never outstandingly profitable, the company had suffered heavy losses in recent years. Competent engineers had pronounced the company's air filter to be a sound device, but its high price had limited the market to those who operated trucks under extremely dusty conditions. However, in 1940 very large orders were received from the Army, so that in October the company's leased plant was operating at capacity and new equipment, to be partly financed by government funds, was being installed.

After receiving the statements shown in Exhibits 1 through 3, the credit department of the Third National Bank wrote the treasurer of the Linwood Company asking for a cash budget to cover the three months from April 1. A prompt reply was received, containing the figures shown in Exhibit 4. The treasurer's letter stated that the estimate was the best possible at the time and that it was based on existing production schedules. The unfilled orders on the books at the beginning of April were $780,101.73, almost entirely from the Army. The treasurer stated that, in making the budget, he had tried to err on the conservative side and pointed out that, in view of the indicated cash losses, further loans from the bank would be required. In response to another inquiry in the bank's

letter, the treasurer stated that it normally took three weeks for the handling of the product from raw material to shipment.

After examining the figures submitted by the Linwood Company, which seemed to him to leave several gaps, the manager of the credit department turned the material over to Mr. Johnson, one of his assistants, and asked him to prepare for a trip to the offices of the company, where an interview with the treasurer would be arranged. If properly conducted, such an interview would provide information necessary for a decision about further loans.

Exhibit 1

LINWOOD COMPANY

BALANCE SHEETS

ASSETS	December 31, 1940		March 31, 1941		Increase or Decrease
Cash		$ 20,592		$ 27,545	$ 6,953
Accounts receivable:					
U.S. government	$ 23,249		$ 47,868		24,619
Other			8,877		8,877
	$ 23,249		$ 56,745		
Less: Reserve for bad debts	1,164	22,085	1,212	55,533	48[d]
Inventories:					
Supplies	$ 952		$ 1,414		462
Raw material	47,988		86,270		38,282
Work in process	7,896		11,414		3,518
Finished goods	8,226	65,062	43,219	142,317	34,993
Current assets		$107,739		$225,395	$117,656
Prepaid expenses		476		3,502	3,026
Special deposits on bids		......		1,047	1,047
Machinery and equipment	$161,940		$215,173		53,233
Less: Reserve for depreciation	77,304	84,636	78,998	136,175	1,694[d]
Due from U.S.—machinery installed		......		31,437	31,437
Advanced payments on machinery		1,975		......	1,975[d]
Total assets		$194,826		$397,556	$202,730
LIABILITIES					
Demand notes payable		$118,500		$325,000	$206,500
Accounts payable		33,214		47,642	14,428
Accrued items		4,704		13,871	9,167
Current liabilities		$156,418		$386,513	$230,095
Stock outstanding		90,000		90,000	......
Deficit		51,592		78,957	27,365
Total liabilities		$194,826		$397,556	$202,730

[d] Decrease.

Exhibit 2

LINWOOD COMPANY

INCOME STATEMENTS

	December 31, 1939–1940			December 31, 1940—March 31, 1941		
Gross sales:						
Trade	$178,663					
Less: Returns and allowances	5,166	$173,497	67.60%	$191,131		101.59%
Government	$ 85,764			2,996	$188,135	1.59
Less: Returns and allowances	2,613	83,151	32.40			
Net sales		$256,648	100.00%		$188,135	100.00%
Cost of goods sold		240,949	93.88		191,776*	101.94
Gross profit		$ 15,699	6.12%		$ 3,641[d]	1.94%[d]
Selling and delivery expense	$ 15,615		6.09	$ 1,581		0.84
Administrative and general expense	22,918	38,533	8.93	16,263	17,844	8.64
Net operating loss		$ 22,834	8.90%		$ 21,485	11.42%
Discounts taken	$ 699		0.27	$ 2,590		1.38
Recoveries of bad debts	64		0.02	......		.....
Miscellaneous income	108	871	0.04	727	3,317	0.39
Discounts allowed	$ 3,568		1.39%	$ 684		0.36%
Interest paid	1,436		0.56	3,060		1.63
Penalties paid U.S. government	306		0.12	954		0.51
Payments to experts	......		.....	2,805		1.49
Depreciation and amortization	......		.....	1,694		0.90
Loss by fire	3,803	$ 9,113	1.48	......	$ 9,197	.....
Net loss		$ 31,076	12.11%		$ 27,365	14.55%

* Detailed figures in Exhibit 3.
[d] Deficit.

Exhibit 3

LINWOOD COMPANY

STATEMENT OF COST OF GOODS SOLD

December 31, 1940—March 31, 1941

		Percentage of Net Sales
Beginning inventory, raw materials	$ 47,988	25.51
Purchases	172,893	91.90
	$220,881	117.41
Less: Ending inventory, raw materials	86,270	45.86
Cost of materials used	$134,611	71.55
Direct labor	43,080	22.90
General plant expenses	52,596	27.96
Beginning inventory, work in process	7,896	4.20
	$238,183	126.60
Less: Ending inventory, work in process	11,414	6.07
	$226,769	120.53
Beginning inventory, finished goods	8,226	4.37
	$234,995	124.91
Less: Ending inventory, finished goods	43,219	22.97
Cost of goods sold	$191,776	101.94

Exhibit 4

LINWOOD COMPANY

CASH BUDGET

April, May, and June, 1941

	April		May		June	
Sales:						
Government	$110,600	87.5%	$138,250	89.7%	$158,000	88.9%
Trade	15,800	12.5	15,800	10.3	19,750	11.1
	$126,400	100.0%	$154,050	100.0%	$177,750	100.0%
Expenditures:						
Materials	$ 93,220	73.7%	$ 75,840	49.2%	$ 75,208	42.4%
Equipment	6,478	5.1	6,478	4.2	200	...
Salaries and wages	29,230	23.1	35,550	23.1	35,550	20.0
Heat, power, freight	14,220	11.3	14,220	9.2	14,220	8.0
Administrative and general expense	6,320	5.0	6,320	4.1	6,320	3.6
Interest	1,422	1.0	1,580	1.0	1,580	0.9
	$150,890	119.2%	$139,988	90.8%	$133,078	74.9%
Cash gain or (loss) for month	($ 24,490)	19.4%	$ 14,062	9.2%	$ 44,672	25.1%
Cumulative cash gain or (loss)	(24,490)		(10,428)		34,244	

Trivett Manufacturing Company (A)

In July, 1946, Eldon Brigham, treasurer of the Trivett Manufacturing Company, was reviewing his working capital position. It was his custom to calculate working capital needs for the next six months in January and July of each year and to formulate plans for meeting such needs.

The Trivett Manufacturing Company, which had been founded in 1934, operated a small machine shop in a Philadelphia suburb. The company had originally manufactured lapping plates and made gauges and special tools on order. In 1941 a newly designed industrial stapling machine was added to its line.

Operating losses and poor financial management had kept the company in financial difficulty during the greater part of its early history. Matters were made worse by a conflict which developed between the common and preferred stockholders. Inability of these two groups to agree had prevented the taking of corrective measures.

In the spring of 1942 this situation came to the attention of Mr. Brigham, a businessman who specialized in rehabilitating financially weak concerns. He analyzed the company and found that it had in its employ a number of skilled machinists and possessed good equipment suitable for precision work. Mr. Brigham was also impressed by postwar prospects for the company's stapling machine, which was far superior to competitive products. As a result of his analysis Mr. Brigham concluded that with competent management the company could be operated profitably. The two stockholding groups were approached, and an agreement worked out whereby Mr. Brigham became, in effect, head of the company. For his efforts he was to receive a fixed salary plus a percentage of profits. Mr. Brigham, who was an officer of a number of other concerns, was to devote only part of his time to the Trivett Manufacturing Company.

During the war Mr. Brigham concentrated on obtaining fixed fee Army contracts for the manufacture of precision instruments. Because of rigid economies which he instituted these contracts proved highly profitable, even after renegotiation. Wartime profits and Mr. Brigham's skillful financial management soon rehabilitated the company. By the end of 1944 the deficit accumulated during many years of unprofitable operations had been eliminated.

The ending of hostilities in August, 1945, brought cancellation of the company's Army contracts. Mr. Brigham immediately took steps to curtail overhead and administrative expenses, but he retained the company's skilled machinists.

Sales and production efforts were concentrated on the industrial stapling machine. Prewar prices on the company's lapping plates had been about 50% less than for standard makes. As a result, the prices which the OPA would permit the company to charge currently were set at a level that Mr. Brigham considered too low. Until a better price could be obtained he did not intend to manufacture plates. Furthermore, since there was sharp price competition for gauge and tool work in the locality after V-J Day, Mr. Brigham decided that no effort should be made to seek this type of business for the time being.

Demand for the stapling machines was good. Monthly shipments during the first half of 1946 averaged about 75 units priced at $200 each. More units could have been sold and shipped, but Mr. Brigham did not wish to risk overextending the company while conditions were so unsettled.

Balance sheets and operating statements for 1944, 1945, and the first six months of 1946 are shown in Exhibits 1 and 2 (pp. 60–61).

Early in May an invitation was received to bid on an Army contract for the manufacture of 301 gun sights. Mr. Brigham thought that a good profit could be made on the sights, and so he decided to submit a bid. His first bid of $720 a unit was rejected, but a second bid of $615 was accepted. One "pilot" sight was to be produced during August for the purpose of testing design and production methods. It was to be retained at the plant but invoiced on September 1 at $615. This experimental unit was to be manufactured from materials on hand. Direct labor for this model was estimated at $500. The lessons learned during the making of the first unit were expected to enable the company to start gun sight production at full scale about September 1. Production was expected to be maintained at a fairly constant rate until November 30.

Delivery of the sights was to start the first week in October and was to be made at the rate of 100 units a month during October, November, and December.

Estimated per unit direct costs of producing the gun sight were as follows: labor, $242; material, $128.

In addition to the estimated direct labor cost of $242 per unit, Mr. Brigham estimated that the build-up of the additional labor force needed for gun sight production would require $2,500 in extra wage expense during August. Similarly, $3,000 of additional wage expense was budgeted for December so as to permit less abrupt reduction of the work force upon completion of the contract. Virtually all of the $3,000 would be paid out in the first three weeks of December.

To insure against delays in delivery, Mr. Brigham intended to keep a minimum of one month's supply of raw material for the gun sight on hand at all times during the production period. Work-in-process inventory for gun sight production was expected to average $20,000 during the period of full-scale production. The great majority of the company's purchases were made on terms of net/30, and invoices were paid promptly when due. Wages were paid every Friday.[1] The production process from raw material to finished product was estimated to take a month. The Army would accept shipments in lots of 25 units, and payment would be received about 60 days after shipment.

Estimated per unit direct costs of producing the stapling machine were as follows: materials, $40; labor, $36. A minimum inventory of a three months' supply of raw material was currently considered necessary because of unsettled conditions. Work-in-process inventory for stapling machine production was expected to continue at the present level. All current inventory was usable. The length of the production process was four weeks. Units were shipped as soon as produced, and terms of sale were net/30. The company had a backlog of orders for 350 machines. Production and shipments, however, were expected to continue at the rate of about 75 units a month through the first quarter of 1947.

Monthly indirect expenses were currently running as follows: depreciation, $540; other factory overhead, $3,500; administration, $2,350. Tooling for the gun sight contract started in July. During July and August tooling expenses and experimental manufacture of the pilot gun sight were expected to increase factory overhead by about $1,200 a month. Starting in September, when full-scale production of

[1] There were four paydays in July, five in August, four in each of September and October, five in November, and four in December.

the gun sight was to begin, factory overhead was expected to become about $4,500 a month until the end of November. Administration expense was expected to increase to about $3,000 a month from September 1 to the end of December.

The Army contract had made necessary the purchase of $2,000 of special tools. Delivery of these tools was expected in August; payment terms were C.O.D. Upon completion of the contract these tools would be scrapped. An additional $5,000 might also have to be spent for the replacement of old machinery which appeared to be nearing the end of its useful life. There was no way of knowing, however, when this machinery would finally break down. Mr. Brigham was confident that he could find replacements within a few days in the event of an emergency. The machinery to be retired was fully depreciated.

Mr. Brigham worked out a tentative purchase schedule for the various material requirements. The schedule is reproduced as Exhibit 3. It shows the amounts of purchases in the months that they were expected to be booked.

The company maintained a small deposit account with a local bank and kept the remainder of its cash in an account with the Fourth National Bank of Philadelphia. The company had originally banked with the Farmers and Merchants Bank, a small local institution, from which it had borrowed from time to time during the war to help finance production on government contracts. Toward the end of the war, however, Mr. Brigham sensed that Mr. Appleseed, the bank's president, was becoming apprehensive about lending money to the company. Mr. Brigham attributed this reluctance to the fact that Mr. Appleseed had had little experience in lending money to industrial concerns; the greater portion of the bank's commercial loans were to local storekeepers. Therefore, Mr. Brigham withdrew his account from the bank. A small account was opened at another local bank, and the remainder of the company's funds were deposited with the Fourth National Bank of Philadelphia, a medium-sized bank with a legal loan limit of $150,000. Mr. Brigham had discussed the company's prospects in general terms with the bank's officers on a number of occasions, but he had never requested a loan.

Mr. Brigham considered his current cash balance of almost $28,000 to be in excess of operating needs. He was willing to reduce cash to a minimum of $5,000. No dividend payments were scheduled for the remainder of 1946.

It was Mr. Brigham's policy not to plan more than six months in

advance, since he believed that it was impossible to predict with any accuracy what was going to happen for a longer period. The company's plans for the first half of 1947 would be made in the light of conditions as they developed and of the company's prospective financial condition at the end of 1946.

Exhibit 1

TRIVETT MANUFACTURING COMPANY

BALANCE SHEETS

ASSETS	*Dec. 31, 1944*	*Dec. 31, 1945*	*June 30, 1946*
Current assets:			
Cash	$ 12,982	$ 16,066	$27,753
Accounts receivable, net	48,107	29,583	19,593
Inventory	45,514	34,016	......
Raw material	......	......	13,134
Work in process	......	......	6,636
Prepaid items	725	1,179	325
Total current assets	$107,328	$ 80,844	$67,441
Fixed assets:			
Property account	$ 46,507	$ 47,153	$47,776
Less: Reserve for depreciation	14,534	19,916	21,057
Property account, net	$ 31,973	$ 27,237	$26,719
Total assets	$139,301	$108,081	$94,160
LIABILITIES AND CAPITAL			
Current liabilities:			
Accounts payable	$ 27,668	$ 17,338	$ 9,066
Accrued liabilities	9,592	1,836	4,777
Reserve for previous year's federal taxes	8,172	4,891	12,095*
Reserve for current year's federal taxes	8,451	24,649	4,486†
Accrued taxes	6,381	2,736	1,812*
Total current liabilities	$ 60,264	$ 51,450	$32,236
Fixed liabilities:			
Due officers	13,834	......	......
Due U.S. government on contract advances	21,996	......	......
Capital:			
Preferred stock, 6%	21,000	21,000	21,000
Common stock, $100 par	17,000	17,000	17,000
Surplus	5,207	18,631	23,924
Total liabilities and capital	$139,301	$108,081	$94,160

* Payable in equal installments, September 15 and December 15, 1946.
† Payable in equal installments, March 15, June 15, September 15, and December 15, 1947.

Exhibit 2

TRIVETT MANUFACTURING COMPANY

OPERATING STATEMENTS

	Year 1944	*Year 1945*	*6 Months Ending June 30, 1946*
Sales, net	$282,888*	$331,575*	$86,966
Cost of sales:			
Material	$ 36,548	$ 97,065	$21,680
Direct labor	116,366	85,758	15,279
Depreciation	6,515	5,382	3,242
Factory overhead	52,842	47,940	20,514
Gross profit	$ 70,617	$ 95,430	$26,251
Less: Administration expense:			
Shipping expense	$ 9,561	$ 5,886	$ 235
Selling expense	10,442	7,480	......
Other expense	31,533	43,300	14,775
Net operating profit	$ 19,081	$ 38,764	$11,241
Other charges	308	521	......
Net gain before federal taxes	$ 18,773	$ 38,243	$11,241
Less: Federal taxes	8,450	24,183	4,486
Net profit	$ 10,323	$ 14,060	$ 6,755

* After adjustment for renegotiation.

Exhibit 3

TRIVETT MANUFACTURING COMPANY

TENTATIVE SCHEDULE OF PURCHASES

July–December, 1946

	July	*Aug.*	*Sept.*	*Oct.*	*Nov.*	*Dec.*
Raw material—stapler	....	$ 1,994	$ 3,000	$ 3,000	$3,000	$3,000
Raw material—gun sight	....	12,800	12,800	12,800	.....	.....
Special tools—gun sight	....	2,000	.....	.....	.....	.....
Total	....	$16,794	$15,800	$15,800	$3,000	$3,000

Replacement machinery ...$5,000 (uncertain date)

Trivett Manufacturing Company (B)

In July of 1946, Mr. Lyman Huffman, a vice-president and loaning officer of a medium-sized Philadelphia bank, the Fourth National Bank, had a visit from Mr. Eldon Brigham, treasurer of the Trivett Manufacturing Company. Mr. Brigham explained that his firm had recently received a contract for the manufacture of 300 gun sights for the U.S. Army. The contract was to be completed within six months, and the work on the contract would be in addition to the company's regular production of a line of stapling machines.

According to a projected income statement for the next six months, which Mr. Brigham brought with him, the contract promised to be very profitable. However, much additional working capital would be needed to finance the operations of the company during the period. Speaking from a schedule of anticipated cash receipts and expenditures for each of the last six months of 1946, Mr. Brigham explained that according to his estimates as much as $100,000 might be required to complete the order as planned. Such a large loan would be required for only a brief time, Mr. Brigham felt. As work on the order was completed and payments began to come in from the Army, the company's cash position would improve and repayment of the loan could begin. Mr. Brigham estimated that repayment could be completed by the end of February, 1947.

Since money was not needed at once, Mr. Brigham asked that the company be granted a line of credit under which the company could borrow as needed up to $100,000 on short-term notes.

After looking over the June 30 balance sheet of the company, Mr. Huffman observed that $100,000 was a very large loan for a small company. Mr. Brigham seemed somewhat annoyed at this comment and replied that he thought this was just the kind of self-liquidating loan proposition that commercial banks liked. He added that he had recently

been approached by a finance company which would be very happy to have this business. Mr. Huffman quickly stated that the Fourth National Bank had always held the reputation of being a progressive bank, and that the bank was definitely interested in Mr. Brigham's request. On the other hand, he felt that the bank owed a real obligation to its many depositors to protect their funds. Accordingly, he asked Mr. Brigham to leave with him the pro forma statements and cash budget he had prepared, so that he and other members of the bank's loan committee could study the proposal. He promised that Mr. Brigham would hear from him within a few days. After a brief discussion, Mr. Brigham asked Mr. Huffman to telephone him if the material raised any questions which he might answer.

Mr. Huffman was somewhat familiar with the affairs of the Trivett Manufacturing Company since he had talked about the company in general terms with Mr. Brigham on several occasions after the company had opened a deposit account something more than a year before. He had formed a rather favorable impression of Mr. Brigham and the company, and a review of the brief file that had been built up on the company indicated that it paid its bills promptly and enjoyed a good reputation in trade circles.

Mr. Huffman's responsibilities as the loaning officer responsible for the Trivett account included: all necessary analysis and investigation of the credit; decision on the terms of a loan, including collateral, maturity, and interest; and oral presentation of his recommendations before the bank's loan committee. This group, made up of senior officers, sometimes reviewed a proposal thoroughly through their questioning and discussion.

Harbin Company

On July 30, 1946, the officers' loan committee of the Fifth National Bank of Philadelphia was scheduled to vote on a proposed loan to the Harbin Company. The Fifth National Bank was a relatively moderate-sized bank, with a legal loan limit of $190,000. The bank's staff was small but highly efficient. Its loan officers had a reputation for imagination and initiative and often tried to work out loans in situations which most of its competitors would have given up as unsuited to a commercial bank.

The material in this case consists of excerpts from the credit file maintained by the bank. This file was typical of such material as collected by many banks on active loan accounts. It was divided into the following four sections for the Harbin account: correspondence; financial statements, as shown in Exhibits 1 and 2 (pp. 70–71); agency reports; and information. The latter section, which contained a summary of discussions relating to the loan, may be summarized as follows:

6/21/46

Harbin [president of the Harbin Company] was introduced to Mr. Bancroft [president of the Fifth National Bank] by Charles Parkman [a friend of Mr. Bancroft's], attorney for Harbin.

The Harbin Company is engaged in selling bakery supplies and machinery. It was formed in February, 1943, by Associated Enterprises, Inc., for the purpose of carrying on a bakery supplies business purchased from City Supply Company. Associated Enterprises, Inc., is a holding company which controls a number of concerns in a variety of industries. City Supply Company is engaged in selling supplies and machinery to a number of industries throughout the eastern United States. Harbin was formerly with City Supply Company and decided to accept the position of manager of the new concern at the time of its organization.

Associated Enterprises, Inc., has offered to sell the entire capital stock of the Harbin Company to Harbin for $250,000. He feels that he can get them to accept $200,000. It will be necessary for him to borrow a substantial proportion of this amount.

After my first discussion with Harbin, I believe that we could make the loan only on the basis of the assignment of accounts receivable or inventory. Before proceeding further we should have Commager [a member of the bank's staff who specialized in accounts receivable loans] investigate these.

JWC [John W. Channing, a vice-president]

6/26/46

The company maintains offices and a warehouse at 407 Prune Street. It is engaged in the distribution of supplies and machinery to commercial bakeries and institutions in the Philadelphia area. Terms of sale are n/30, but Mr. Harbin advised me that the turn of receivables in the trade averages between 50 and 60 days. Machinery is sometimes sold on a deferred payment plan arranged with Supplier's Finance Company of New York City. I have checked with Mr. Ball, the Harbin Company's credit man, who has informed me that collections on deferred payment notes have been good.

Twenty-five per cent of the receivables, as of June 1, 1946, were selected at random and aged. The results are as follows:

	Outstanding		%
May shipments	0–30 days	$22,022.33	44
April shipments	31–60	7,006.24	14
March shipments	61–90	6,389.05	13
Prior shipments	90+	14,641.99	29
Total		$50,059.61	100

Of the above total, $42,782.09 was comprised of accounts of $100 or more. Dun & Bradstreet's rating of these accounts is as follows:

		%
1st grade	$ 4,893.91	11
2nd grade	4,571.16	11
3rd grade	4,364.94	10
4th grade	1,051.81	3
Not rated	27,900.27	65
Total	$42,782.09	100

Of the remaining 75% of the receivables, all accounts of over $100 were aged. The results are as follows:

	Outstanding		%
May shipments	0–30 days	$ 75,469.14	48
April shipments	31–60	21,459.41	14
March shipments	61–90	17,105.67	11
Prior shipments	90 +	43,482.76	28
Total		$157,516.98	100

Invoices in the supply end of the business average about $50. Returns and allowances average about 6.6% of shipments.

I was favorably impressed with Mr. Ball, the credit man, who has been with the company since March 1. He has installed a new control system, which keeps him constantly informed on the status of the accounts. Improvement has been made in at least 75% of the accounts since the hiring of Mr. Ball.

Mr. Mack, the office manager, also impressed me favorably. He appears to have his records in excellent condition and is very co-operative. With Mr. Mack and Mr. Ball on the job I believe that the detail work connected with an accounts receivable loan could be handled without undue difficulty and confusion.

Mr. Harbin took me through his warehouse. The supplies inventory appeared to be in good shape and fast moving. The machinery stock consists mostly of trade-ins. Mr. Harbin told me that there is a good profit on trade-ins. He is going to furnish a complete inventory of supplies and machinery in a day or two.

Mr. Harbin remarked that he hoped that we could get together because he would prefer to do business with us rather than with Acme-Eastern Credit Corporation, which has offered to finance the purchase.

WCC [Mr. Commager]

7/2/46

I have studied Commager's report and the company's financial statements; the following unfavorable factors stand out:

1. The poor class of receivables
2. Consistent losses

Against these we must consider the following favorable factors:

1. The accounts are well diversified. If we allow ourselves sufficient margin they would be satisfactory collateral.
2. The prospects for the bakery business look good for some time to come.

If the company could be put on a profitable basis, which is possible if extraneous expenses are eliminated, we might consider the loan on this basis:

1. 70% advance on receivables, limit of $145,000, and interest and service fees to total not less than 8% annually.
2. A minimum of $25,000 should be invested as additional working capital.
3. A starting minimum net working capital of $145,000, with provision in the loan agreement that net working capital should not fall below $125,000.
4. No pledge of any other assets.

Using May 31, 1946, balance sheet figures [given in Exhibit 2], if the above were done the company would show the following approximate position after paying off its current bank loan:

Current assets:		Current liabilities:	
Cash	$ 8,500		
Accounts receivable	199,000	Banks	$145,000
Inventory	197,000	Other	114,000
	$404,500		$259,000

Harbin mentioned that he had $25,000 that he could invest. If he can get the price down to $200,000, he plans to give notes for $55,000 of the amount so as to be able to put the $25,000 into the business.

JWC

7/6/46

Harbin was in today, and we discussed the following:

1. Operating results for fiscal year ending August 31, 1945, after making adjustments for extraneous expenses.
2. The maximum loan that we would be willing to consider, and the basis thereof.
3. Method of purchasing the company in the event the loan is approved.

Prospects for future operations are not bad, judging from the adjusted figures for the fiscal year 1945. [See Exhibit 1.] Unamortized nonrecurring expenses could be written off to surplus immediately without affecting working capital or future earnings. Consideration should be given to the unfavorable conditions prevailing during the period. The company was unable to get new machinery, which ordinarily comprises a substantial proportion of sales, and was unable to get its normal supply of certain types of yeast.

Harbin states that he prepared his adjusted operating statements with a great deal of care and on a basis that he is confident he can attain. Reduction in selling expense will be achieved by transferring to sales two inside men who are not needed full time in their current jobs, thereby enabling the company to discharge two salesmen. Bad debt expense has been reduced because losses have averaged only $2,000 a year. Harbin justifies the decrease in cost of sales from 79% of sales to 77% on the ground that cost was only 76% in the previous period.

I am impressed with Harbin's presentation and the thinking behind it, and I am confident that he can meet his estimates.

We went over the adequacy of a $145,000 loan, if we can see our way clear to making it. I advised against a larger amount because it would tie up all the company's assets, thereby curtailing its sources of additional credit. Harbin agreed that a larger loan would be inadvisable. I suggested that he raise $50,000 cash, which he replied he could do. If the company can be had for $200,000 I suggested that he arrange that $55,000 be paid in the form of a five-year note.

The following method of purchasing the company was worked out. The proceeds of the proposed loan would be used to purchase its stock for the company's account. This stock would then be canceled. The remainder of the outstanding stock would be purchased by Harbin for his own account, payment being made by his personal note as described in the preceding paragraph. Harbin would thereby own 100% of the outstanding shares.

The pro forma balance sheet giving effect to the proposed transaction is as follows:

Current assets:		
Cash	$ 33,000	
Net receivables (pledged)	199,000	
Inventory	197,000	
	$429,000	

Current liabilities:	
Bank debt	$145,000
Trade debt	114,000
	$259,000
Net working capital	170,000

JWC

[Extract from summary of officers' loan committee meeting of July 9, 1946.]

A revolving credit up to $145,000 based on pledged accounts receivable for the purpose of financing the purchase and operation of the business by Mr. Harbin was presented for discussion by Mr. Channing.

A suggestion was made by Mr. Harlow [chairman of the officers' loan committee and senior vice-president] that a thorough check be made into the moral standing and ability of Mr. Harbin and into the company's position in the trade and its prospects. Mr. Harlow stated that, in his opinion, too much reliance was being placed on Mr. Harbin's word without adequate outside corroboration.

7/10/46

Met on Tuesday with Harbin and his attorneys to discuss the possible basis for the loan, pointing out that it had not been approved. They seemed satisfied with: 75% advance on receivables, limit of $145,000, and interest rate of 6%, no less, plus a service charge of 2% to cover clerical costs in handling invoices.

The question was raised of an additional loan if Harbin were unable to get the price down to $200,000. I replied that in that event I would discuss with our loan committee the possibility of a chattel mortgage on inventory for the additional amount.

JWC

7/13/46

Had lunch with Harbin. I told him that after reconsidering my previous statement about increasing the loan I had come to the conclusion that any amount in excess of $145,000 would be unsound from his point of view as well as from ours. He suggested that the $50,000 he planned to put in the business could be applied, if necessary, to the purchase. I said that we would cross that bridge when we came to it. Meanwhile, I recommended that he continue his negotiations with Associated Enterprises.

JWC

7/18/46

I have made inquiries through friends about Harbin and the company. His former employers, the City Supply Company, have a high regard for his honesty and business ability. Harbin is respected by his competitors and is well and favorably known in the local bakery trade. There were a number of favorable comments on his ability and experience as a salesman. He will have good assistants to handle routine work. Mack has the office and books in good shape, and we are counting on him and Ball to handle the figure work.

JWC

7/26/46

Harbin was in today and was in high spirits. With the aid of friends he has been able to raise a total of $75,000. He also stated that Associated Enterprises has agreed to accept as part payment a $55,000 five-year note secured by all the capital stock left outstanding after cancellation of stock purchased by the company with the proceeds of the loan. He expects the negotiations to be completed within the next two weeks but has not been successful yet in having Associated agree to the figure of $200,000. It looks as if they will not be agreeable to the new price.

If the deal goes through at $250,000, the money will be raised as follows:

Loan from us to company, secured by accounts receivable	$145,000
From Harbin and friends	75,000
5-year note given by Harbin to Associated Enterprises	55,000
	$275,000
To Associated Enterprises	250,000
Available funds to be invested in Harbin Company	$ 25,000

As I understand the plans, the transaction would go this way:

a) We loan the Harbin Company $145,000 against its accounts receivable.

b) The company uses the $145,000 to buy 145/250ths of its stock from Associated Enterprises. This stock would be canceled.

c) Mr. Harbin buys the remaining stock from Associated Enterprises. He pays $50,000 in cash and gives his personal note for $55,000 to Associated Enterprises. He also posts his stock holdings as collateral for the $55,000 note.

d) Mr. Harbin puts $25,000 in the business in return for common stock to be issued by the company to him.

Following these transactions the current asset and liability picture (working from May 31, 1946 figures) would be changed to following:

Current assets:		
Cash	$ 9,000	($18,000 on 5/31 + $25,000 new money less $34,000 used to pay old loan)
Accounts receivable	199,000	(Pledged to us)
Inventory	197,000	(Same as 5/31)
	$405,000	
Current liabilities:		
Bank debt	$145,000	(Old loan of $34,000 paid off)
Accounts payable and accrued items	114,000	(Same as 5/31)
	$259,000	
Net working capital	$146,000	

JWC

Exhibit 1

HARBIN COMPANY

OPERATING STATEMENTS

	Actual 6 Months to Aug. 31, 1944	*Actual 12 Months to Aug. 31, 1945*	*Adjusted 12 Months to Aug. 31, 1945*	*Actual 9 Months to May 31, 1946*
Sales	$384,237	$956,259	$956,259	$695,286
Less: Cost of sales	291,789	754,992	736,695	552,762
Gross profit	$ 92,448	$201,267	$219,564	$142,524
Add: Commissions	6,741	578	578	362
Total	$ 99,189	$201,845	$220,142	$142,886
Less: Operating expenses:				
Selling expense	$ 34,668	$ 74,151	$ 66,929	$ 51,424
Advertising	3,852	5,297	4,334	1,830
Collection expense	96	556	556	418
Provision for bad debts	7,705	10,015	4,815	7,237
Royalties	1,348	1,926	1,926	1,422
Handling expense	11,171	28,890	28,890	24,687
Machine shop expense	963	963	963	1,787
Administrative expense	9,437	24,653	24,653	17,351
Office expense	16,371	40,831	40,831	28,120
Balance	$ 13,578	$ 14,563	$ 46,245	$ 8,610
Add: Discounts received	3,178	10,305	10,305	9,004
Total	$ 16,756	$ 24,868	$ 56,550	$ 17,614
Less: Other charges:				
Interest paid	$ 763	$ 1,926	$ 1,926	$ 963
Discounts allowed	2,793	8,667	8,667	7,896
Profit before amortization of nonrecurring expenses	13,200	$ 14,275	$ 45,957	$ 8,755
Less: Amortization	6,081	28,332	None	15,200
Net profit or loss	$ 7,119	$ 14,057[d]	$ 45,957	$ 6,445[d]
Dividend paid	.....	....	....	$ 6,428

[d] Loss.

Exhibit 2

HARBIN COMPANY

BALANCE SHEETS

(Dollar figures in thousands)

ASSETS

	Aug. 31 1944	Aug. 31 1945	May 31 1946
Current assets:			
Cash	$ 38	$ 67	$ 18
Accounts receivable (net)	126	149	199
Inventories (net)	125	177	197
Total current assets	$289	$393	$414
Other assets:			
Machinery and fixtures (net)	11	13	13
Other notes and accounts receivable	1	5	8
Prepaid items	7	10	6
Organization expense*	44	15	8
Purchase of officer's contract*	...	19	11
Total assets	$352	$455	$460

LIABILITIES AND CAPITAL

	Aug. 31 1944	Aug. 31 1945	May 31 1946
Current liabilities:			
Bank loans	...	$ 48	$ 34
Accounts payable	$ 38	54	104
Accrued items	11	14	10
Reserve for federal taxes	3	...	...
Deposits on containers	8	13	...
Due to affiliated company	49	1	...
Total current liabilities	$109	$130	$148
Capital:			
Common stock—$10 par	$241	$289	$289
Earned surplus or deficit	2	12[d]	25[d]
Capital surplus	...	48	48
Total capital	$243	$325	$312
Total liabilities and capital	$352	$455	$460

[d] Deficit.
* Nonrecurring expenses being amortized (Exhibit 1).

Santos Coffee Company

Early in July, 1947, Mr. John Richards, a credit officer of the Free State Bank of Baltimore, Maryland, was considering what action the bank should take regarding a large unsecured loan to the Santos Coffee Company. In recent months a series of undesirable developments in connection with the loan had convinced Mr. Richards that the present situation was highly unsatisfactory from the bank's viewpoint. It seemed to him that unless the loan could be covered by adequate security the bank would have to insist on payment of the loan even though such action might result in liquidation of the company. Since the company owned little real property, the only possible collateral was the company's accounts receivable and inventory.

The Santos Coffee Company had been founded in 1929 by four salesmen who had worked previously for a large coffee roasting firm in Baltimore. The new company operated as an importer, roaster, and wholesaler of coffee.

The company customarily ordered its principal raw material, green coffee in bean form, from Brazilian exporters. Shipment was made from Santos, the principal coffee exporting port of Brazil. The method by which payment for the coffee was accomplished is outlined as follows: When a shipment was loaded aboard ship, the Brazilian exporter drew a draft on the Santos Coffee Company for the agreed dollar value of the shipment. The draft usually called for payment "on sight," that is, within three days after presentation of the draft to the company. With "shipping papers"[1] attached, the draft was then deposited for collection by the Brazilian exporter at its bank. This bank forwarded the draft and attached papers to its correspondent bank in the United States, which in turn sent it on to the Free State Bank, which paid the draft as instructed

[1] Consisting typically of invoices, ocean bill of lading, marine insurance certificates, and consular certificates.

by the Santos Coffee Company. Upon payment of the draft, the Free State Bank turned over the shipping papers to Santos, so that it could claim the coffee upon arrival in Baltimore.

Soon after the Santos Coffee Company moved its account to the Free State Bank in 1934, it arranged to borrow up to $30,000 from the bank to meet drafts for shipments of coffee. As the bank advanced the funds to pay for a particular shipment, it prepared a demand note for the amount of the advance. The note also gave the bank legal title to the coffee until the note was paid. Although the bank held title to the coffee, it released the coffee to the company for storage under a legal arrangement known as a "trust receipt." It was the customary practice of the company to pay the note secured by a particular shipment of coffee when it removed that coffee from storage for processing. Each trust receipt identified the particular shipment involved by reference to distinctive marks on the coffee bags in that shipment.

During the 10 years from 1934 to 1944, the company's sales gradually increased and the amounts of money advanced for the company by the bank against coffee also increased. The bank also made additional unsecured advances to the company on a demand basis from time to time. By 1944, total advances to the company amounted at times to as much as $40,000. Since the company continued to show modest profits and sales increased somewhat, and since the company had only small debts owing to other creditors, the bank had taken no steps to see that the company was fully carrying out its obligations under the trust receipt arrangements. For example, the bank made no inspections of the inventory outstanding under the various trust receipts to make sure that it could be readily identified and that the company had reported promptly all withdrawals from storage. In the absence of these precautions, the bank regarded the advances against coffee under the trust receipts as, in fact, unsecured loans.

In 1944, Mr. John Stone, who had served as president of the company since its inception, died. Mr. Stone was succeeded by Mr. R. H. Sager, formerly sales manager for the company. At the time the bank was somewhat concerned about the future management of the company, since all of the remaining officials were experienced primarily in the sales aspects of the business. Operations continued satisfactorily, however, and a profit of more than $5,000 was recorded in 1945. Late in 1945 the bank learned that Mr. Pierre LeBlanc, one of the salesmen, had purchased Mr. Stone's shares of common stock from his estate. This gave

Mr. LeBlanc 385 shares out of the total of 890 shares outstanding. Consequently, Mr. LeBlanc assumed direction of the company with the title of vice-president and general manager.

Under Mr. LeBlanc's leadership the company undertook a program of aggressive sales promotion. Sales were made principally to independent retailers and to restaurants and hotels. In 1946 the company had more than 3,400 accounts in Maryland, the District of Columbia, Virginia, and southern Delaware. Late in 1946, subsequent to the removal of OPA price restrictions on coffee, there was a sharp increase in both the price of green coffee and in the company's selling prices. However, the increase in prices accounted for only a portion of an increase in net sales from $432,000 in 1945 to $781,000 in 1946. Profits increased from $5,472 to $9,537.

During the latter part of 1946 the bank agreed to increase the amount of credit granted to the company in view of the increased working capital requirements as a result of higher sales and higher prices. A tentative maximum line of credit of $80,000 was established.

Early in January, 1947, Mr. LeBlanc requested that the line of credit be increased further. He explained that the company was currently spending large amounts on advertising and expected a further increase in sales. Mr. Richards had agreed to the increase in the line of credit in late 1946 to $80,000 with considerable reluctance since he felt that the additional sales should more properly be financed by increased capital investment by the owners. Therefore, he declined to advance the line beyond $80,000 but promised to lay the matter before the officers' loan committee of the bank.

Shortly thereafter, in late January, 1947, Mr. Richards had a telephone call from an officer of the Chesapeake Trust Company, who informed him that the Santos Coffee Company had opened a borrowing account with the Chesapeake Trust Company in the fall of 1946 and was currently borrowing some $35,000 from that bank. The other banker expressed some dissatisfaction with his new account particularly when Mr. Richards told him that this was the first news the Free State Bank had that Santos was borrowing from another bank. Shortly thereafter the Free State Bank received a copy of the audited annual report as of December 31, 1946, which confirmed the fact of outside borrowing. The balance sheet of the company on December 31 showed "notes payable to banks" of $105,000. Since $70,000 was outstanding from the Free State Bank, $35,000 was apparently owing the Chesapeake Trust

on that date. Other payables also showed a substantial increase over the 1945 figures. Accordingly, Mr. Richards asked Mr. LeBlanc to come in and see him. In an ensuing discussion, he expressed dissatisfaction with Mr. LeBlanc's action in borrowing from another bank without informing the Free State Bank. He further stated that the Free State line of credit of $80,000 was based on the assumption that the company would not borrow from any other bank. He stated flatly that if Mr. LeBlanc did not accept this arrangement he would have to pay off all the Free State loans and seek other banking accommodations. Mr. LeBlanc agreed to pay off the loans from the Chesapeake Trust Company and to reduce the scale of his operations so that $80,000 would be sufficient bank credit for the company's needs.

Despite the previous understanding, Mr. LeBlanc soon requested a temporary increase in the loans above $80,000 on the ground that he needed at least 2,200 bags of coffee in stock to meet his sales requirements and that the financing of this much inventory together with the other needs of the business would require an increase in the loan above $80,000. Mr. Richards replied that $80,000 was the bank's top limit and suggested that the company build up its capital through earnings and through the sale of preferred stock. Mr. LeBlanc agreed to undertake to find additional capital.

Early in May a representative of the bank visited the company and made a brief inspection of the inventory. A classification of the inventory of the company on April 30 was obtained. This was as follows:

	Thousands of Dollars
Green coffee	37.6
Roasted coffee	12.6
Tea	15.9
Groceries and miscellaneous supplies	6.8
Manufacturing supplies	38.6
	111.5

Upon inquiry it was learned that the manufacturing supplies consisted largely of glass containers, which had been purchased in quantity during a shortage period. Very recently adequate supplies of tin containers had become available. Since tin containers were regarded as much more satisfactory, the company had shifted back to use of tin. There were more than five carloads of surplus glass containers. When pressed for an appraisal of the value of these containers, Mr. LeBlanc conceded that a loss of as much as $14,000 might be expected when they were sold.

In addition it was learned that recent operations of the company had not proved profitable although sales were large. In another conversation with Mr. LeBlanc, based on this information, Mr. Richards urged him to reduce the currently large expenditures for advertising and to try to reduce the loan to $55,000. Mr. LeBlanc agreed to do so. He also agreed to make available to Mr. Richards the financial statements of the company as of June 30 as soon as they were available.

Copies of the balance sheet and profit and loss statement for the first six months of the year were received by the bank on July 10. (See Exhibits 1 and 2.) Mr. Richards found the statements highly disturbing. Net working capital amounted to only $39,000 compared with total debt of $140,000. In addition, although the first half of 1947 had been a period of general prosperity and good corporate earnings, the Santos Coffee Company showed a loss of $34,000 for the period. At this stage, Mr. Richards was convinced that drastic action was necessary if the bank's interests were to be fully protected and possible loss prevented. While he was determining what action to recommend to the officers' loan committee, he received a call from Mr. Sager, one of the original founders of the firm and the manager during the year intervening between the death of Mr. Stone in 1944 and Mr. LeBlanc's assumption of the job late in 1945. Mr. Sager informed Mr. Richards that the stockholders had determined that a change in management was desirable. Mr. LeBlanc had agreed to resign as general manager and to resume his old duties as salesman. Mr. Sager was assuming the job of treasurer and with other stockholders would assume active management of the company. He agreed that the affairs of the company were in poor shape but expressed the strong hope that the bank would give the new management a chance to pull the company out of its current difficulty. He explained that the large expenditures for advertising had been terminated, that pressure was being put on overdue accounts receivable, that the recent practice of cutting profit margins to get additional sales would be stopped, that salaries were being reduced, and that every step to conserve funds was being taken. He asked Mr. Richards to tell him within a few days what the bank would do in regard to meeting the credit needs of the company.

Mr. Richards was impressed with the earnestness of Mr. Sager's appeal and with his apparent grasp of the management mistakes which appeared to be the cause of the company's difficulties. In view of all the facts, however, Mr. Richards decided that the Santos Coffee Company account should no longer be carried on an unsecured basis. In general,

the Free State Bank had followed a policy of trying to work out of difficult situations, where there seemed a reasonable opportunity to do so, rather than forcing liquidation of borrowing customers.

Mr. Richards first centered his attention on the possibilities of securing a pledge of accounts receivable. In order to get a better idea of the company's accounts receivable, a representative of the bank was asked to undertake an aging of the accounts outstanding on June 30. He reported that the company had several thousand accounts, so that the average balance and the individual invoices were small. Of the $75,000 of receivables outstanding on June 30, $52,000 were current or no more than 30 days overdue. Of the remaining $23,000, $15,000 of the accounts were over 90 days overdue. Returns and allowances were very small.

Mr. Richards next focused his attention on the value of the company's inventory as collateral. Upon investigation he found that the green coffee used by the company consisted primarily of common grades of Brazilian coffee for which there was a continuous and rather wide market in Baltimore and in the neighboring cities. At any one time, part of the coffee was in ocean transit to the company. Green coffee actually on hand, preparatory to being roasted, was stored in vacant space in the building which the company rented. The company felt that it was essential to carry a substantial supply of green coffee, either on hand or en route to it, in order to insure no interruption in its supplies. Such a supply would at current prices amount to between $35,000 and $55,000 in total value. As a part of the retrenchment program, the new management planned to concentrate on the sale of coffee, reducing the June 30, 1947 inventory in tea and other lines.

Upon investigation, Mr. Richards verified his opinion that coffee in the green state could be held for many months without substantial deterioration, provided clean, dry storage was available and no other commodities of strong aroma were stored near by. He also investigated recent movements in green coffee prices. The results of the investigation of prices are shown in Exhibit 3. Mr. Richards learned that the government of Brazil, the country which accounted for more than 70% of world production of coffee, had for a number of years made strenuous efforts to maintain the price of coffee at what it considered reasonable levels. These efforts largely took the form of restriction on coffee exports so that they did not exceed world demand. When necessary, substantial stocks had been destroyed in Brazil in order to reduce supply in the world

market. Consequently, some observers currently felt that the Brazilian government would take energetic steps to try to prevent any substantial decline from the current high prices.

Mr. Richards also investigated the possibility of getting a secured position in regard to the green coffee which would be unquestionably valid against general creditors in the event of bankruptcy of the firm. The trust receipt method of taking security on the coffee left some doubts on this score. He learned that there was an independent public warehouse across the street from the building in which the company operated, which had surplus space available at reasonable charges. He then conceived the following plan for loaning against the inventory: When drafts covering the new shipments of coffee were received, the bank would advance money to meet the drafts. Immediately, trust receipts describing the bags in the shipment would be prepared and executed by the company. Thus, the bank would have a secured position on the coffee while it was in transit. Marine insurance would be carried and made out so as to recognize the bank's security interest in the coffee in transit. When the coffee arrived in Baltimore, it would be moved immediately to the public warehouse. The warehouser would issue a warehouse receipt naming the bank as owner of the coffee. The warehouse receipt would be held by the bank, which would then return the trust receipt to the company. When the company needed the coffee for roasting, it would pay the bank the full amount of the loan advanced against the coffee. Thereupon, the bank would direct the warehouse company to release the coffee to Santos.

Such a procedure, Mr. Richards felt, would insure that the bank could properly identify the security back of the inventory loan and establish beyond challenge the bank's ownership of the coffee. The warehouseman was bonded to perform his duties properly, and the coffee while in the warehouse would be covered by fire and other insurance. The proposed procedure would involve some expense and trouble for the company since it now stored its green coffee in otherwise useless space in its rented building. The company would be required to pay the storage charges of the bonded warehouse and, in addition, would incur expense for trucking and handling charges in and out of the warehouse.

After careful study, Mr. Richards concluded that the bank could probably escape with little or no loss if it demanded payment of the loans now and liquidation of the company resulted. Therefore, the major alternatives now open to the bank seemed to boil down to the following:

1. Demand payment of the loans.
2. Continue to loan to the company reasonable amounts on the basis of a pledge of accounts receivable.
3. Continue to loan to the company by advancing reasonable amounts of funds against drafts for shipments of coffee only if the coffee were moved into the public warehouse immediately upon arrival and warehouse receipts pledged as security for the loan.
4. A combination of 2 and 3.

Exhibit 1

SANTOS COFFEE COMPANY

BALANCE SHEETS

(Dollar figures in thousands)

	Dec. 31 1944	*Dec. 31 1945*	*June 30 1946*	*Dec. 31 1946*	*June 30 1947*
Cash	$ 21	$ 12	$ 14	$ 12	$ 16
Accounts receivable, net	37	47	62	87	75
Inventory	46	65	97	129	88
Total current assets	$104	$124	$173	$228	$179
Machinery and fixtures, net	7	13	18	17	18
Other notes and accounts receivable	2	2	2	2	2
Goodwill	28	28	28	28	28
Prepaid expenses	1	1	2	2	3
Total assets	$142	$168	$223	$277	$230
Notes payable—trade	...	...	...	...	$ 10
Notes payable—banks	$ 21	$ 28	$ 37	$105	74
Accounts payable—trade	2	11	48	26	46
Accrued expense	1	5	3	13	4
Reserve for taxes	4	4	7	4	6
Total current liabilities	$ 28	$ 48	$ 95	$148	$140
Common stock ($100 par)	89	89	89	89	89
Surplus	25	31	39	40	1
Total liabilities	$142	$168	$223	$277	$230

Exhibit 2

SANTOS COFFEE COMPANY

INCOME STATEMENTS

(Dollar figures in thousands)

	Year 1944	*Year 1945*	*6 Months 1946*	*Year 1946*	*6 Months 1947*
Net sales	$310.7	$431.8	$323.7	$780.7	$361.7
Gross profit	55.5	84.2	75.1	180.9	67.2
Administrative and selling expense	51.7	78.4	60.3	161.9	97.2
Operating profit	3.8	5.8	14.8	19.0	30.0*
Other income (purchase discounts)	1.2	2.8	0.9	1.4	0.2
Charges against income	4.8	3.1	7.3	10.9	4.2
Net income	0.2	5.5	8.4	9.5	34.0*
Common dividends	0.9	...	...	...	4.0

* Loss.

Exhibit 3

SANTOS COFFEE COMPANY

AVERAGE SPOT PRICE OF COFFEE IN NEW YORK*

(In cents per pound)

	Jan.	*Feb.*	*Mar.*	*April*	*May*	*June*	*July*	*Aug.*	*Sept.*	*Oct.*	*Nov.*	*Dec.*
1937	11.3	11.8	11.2	11.2	11.7	11.7	11.6	11.4	11.4	11.5	9.4	8.8
1938	8.6	8.1	7.5	7.3	7.6	7.4	7.6	7.9	7.8	8.0	8.1	8.0
1939	7.7	7.8	7.4	7.2	7.3	7.4	7.3	7.6	7.7	7.8	7.4	7.3
1940	7.5	7.4	7.3	7.3	7.2	7.3	7.0	6.8	6.8	7.0	7.2	7.4
1941	7.8	8.3	9.0	9.9	10.8	11.5	12.2	13.4	13.4	13.2	13.1	13.3
1942†	13.4	13.4	13.4	13.4	13.4	13.4	13.4	13.4	13.4	13.4	13.4	13.4
1943†	13.4	13.4	13.4	13.4	13.4	13.4	13.4	13.4	13.4	13.4	13.4	13.4
1944†	13.4	13.4	13.4	13.4	13.4	13.4	13.4	13.4	13.4	13.4	13.4	13.4
1945†	13.5	13.6	13.6	13.6	13.6	13.6	13.6	13.6	13.6	13.6	13.6	13.6
1946†	13.4	13.4	13.4	13.4	13.4	13.4	20.6	22.1	22.1	24.1	26.3	26.4
1947	26.9	27.2	27.7	25.8	23.7	25.3	...	...	...	...	...	...

* Santos No. 4. Source: Bureau of Labor Statistics.
† United States price controls on coffee were in effect during 1942–1946.
Source: *Commodity Year Book, 1948*, "Coffee," p. 165.

Garnet Abrasive Company, Inc.

In October, 1945, A. T. Sohier, treasurer of the Garnet Abrasive Company, Inc., of Philadelphia, Pennsylvania, was convinced that his company would need substantial additional funds for a period of several years; and he was considering the wisdom of recommending to the board of directors that the proposal of two local banks to arrange a term loan be accepted.

The Garnet Abrasive Company, Inc., which was established in 1928 for the manufacture of sandpaper abrasives, had made rapid progress in most years since its inception. The company had been started by Mr. Sohier together with N. C. Carroll, president, and D. M. Oliver, a former vice-president, who had retired in 1944. The organization of the new enterprise indirectly was attributable to the circumstance that when another abrasive manufacturing company, of which Mr. Carroll was then sales manager, was purchased by one of the largest manufacturers in the industry, Mr. Carroll decided not to continue with the company. His decision to resign was influenced by the fact that, as the result of considerable investigation, he had become convinced that there was need for a new unit in the industry and that a new company could operate profitably on a modest scale. He discussed his ideas with Mr. Sohier, who was employed at the time as auditor in a textile manufacturing company, and obtained his co-operation in a plan for organizing such a company. The two men then succeeded in inducing Mr. Oliver to join them in the undertaking.

None of the men had a large fortune, but together they were able to invest a total of $65,000 in the business. They purchased a small plant in an industrial section of Philadelphia and started production of sandpaper. Mr. Carroll devoted his attention largely to sales promotion, while Mr. Sohier concentrated on financial and accounting problems and Mr. Oliver was placed in charge of planning production.

For two years the new company's operations were unprofitable, with losses totaling $40,000. The company became unable to pay its trade debt promptly, with the result that the largest trade creditors threatened to force the company into bankruptcy. A conference of three of the largest of these creditors was called in an effort to postpone drastic action. One supplier agreed not to force the company into liquidation, and the other two major creditors concurred in this decision. This agreement may be considered to be a turning point in the company's affairs.

As one method of conserving funds for necessary operation, the management instituted all possible economies to the point, for example, of reducing unnecessary lighting in the plant to cut down bills for electricity and of substituting glasses at the water faucets to eliminate the cost of paper cups. Even with the co-operation of the trade creditors and the strictest economies, there were times when no cash was available to pay for C.O.D. deliveries of raw materials. On some occasions the employees advanced small amounts in order to permit delivery of materials.

In 1930, shortly after this low point in the company's affairs, two concerns which sold to the building industry large amounts of abrasive products for use with machines they manufactured, commenced buying a large part of their abrasive requirements from the company. With this increased volume of sales, operations became profitable for the first time. Rapid acceptance of the company's product by other customers followed and soon resulted in a volume of production which taxed the capacity of the manufacturing plant. Unlike many concerns, the company's volume of sales and profits grew in each of the depression years.

In 1931 it became necessary for the company to move to a larger plant. The property of a textile manufacturing company which had been liquidated during the depression was for sale and was suited to the company's needs. The plant was served by good rail transportation and a satisfactory supply of labor was available in the neighborhood of the plant. The plant comprised two buildings, each four stories in height. One building was large enough to house all the company's activities at the outset, and the other building was available to take care of any subsequent expansion in operations. The price asked for the property was $55,000. By paying $6,500 in cash and assuming responsibility for an existing mortgage of $48,500, the company acquired the property and moved into the brick building.

Late in 1936, the company sold $250,000, par value, of 7% preferred stock through an investment banking house to several hundred

investors in the environs of Philadelphia. Dividends on this preferred stock had always been paid. The outstanding common stock was increased from time to time by stock dividends but remained in the hands of Messrs. Sohier, Carroll, and Oliver. No common dividends had been paid since 1942. By 1940 the company had become fourth in size in the industry and was using both buildings.

The particular type of abrasive product made by the Garnet Abrasive Company, Inc., consisted of a backing material, usually paper or cloth, that was coated with abrasive grains by the application of specially prepared adhesives. The finished products varied according to the type of backing, the type and size of the abrasive grains used, and the size and shape into which the coated materials ultimately were cut. Inventory cards showed that there were 20,000 different specifications for the finished products.

One widely used group of products was common sandpaper made by the application of flint grains to a stiff paper backing; the market for this group of products was highly competitive. Other types of abrasive materials used included garnet grains which, like flint, were a mineral product but had sharper cutting edges and more durability than the flint grains, and synthetic abrasive grains, such as aluminum oxide and silicon carbide.

The development of the garnet type abrasive paper was, in the opinion of the management, a major factor in its success during the depression years. The cost of producing this abrasive was considerably higher than the ordinary flint paper, but the market was not so competitive and sales produced a better average gross margin of profit than the more competitive flint line. The abrasives made from the synthetic grains also produced a larger gross margin of profit than the flint products.

It was difficult to determine all the uses for the products because of the diversity of industries which were the ultimate consumers. The building industry, the woodworking industry, and the metalworking industry were, by and large, the most important markets. Another major customer was the shoe industry, and a substantial volume was sold to felt hat manufacturers.

Many of the industrial users required that the product be made into special grades and shapes. Although a large portion of the flint product was sold as common 9 × 11 inch sheets of sandpaper to wholesale and retail establishments throughout the country for use by carpenters and others, it was also prepared for industrial users according to their specifi-

cations. The garnet and synthetic products were generally sold to industrial users. Other specifications had been worked out for the abrasive materials sold for machines used in the woodworking and metalworking industries.

There was a constant danger of overstocking the special shapes and sizes. To guard against obsolete inventories the management adopted the policy of producing the unusual grades on order as much as possible, although it was necessary to maintain a small inventory of some grades in order to provide quick service.

The company's volume of sales had increased steadily from 1933 to 1941, but gross profit on sales and net profits had not tended to expand in proportion to the increase in sales. See tabulation of net sales, gross profit on sales, net profits, and earned surplus shown in Exhibit 1. Mr. Sohier attributed the flattening out of sales as well as gross profits during the war years to a number of factors. He believed that sales had failed to increase mainly because of restrictions on building and furniture manufacturing. Profits were reduced by the combined effect of cost increases and price ceilings. During the war, munitions establishments in the area had paid considerably higher wages than had the company. As a result many employees left and those who remained tended to become dissatisfied and to be less efficient. The company had found it necessary to increase its hourly wages in an attempt to offset these factors. Labor cost

Exhibit 1

GARNET ABRASIVE COMPANY, INC.
INCOME DATA
(Dollar figures in thousands)

	Net Sales	*Gross Profit on Sales*	*Net Profit after Taxes*	*Per Cent Gross Profit to Sales*	*Earned Surplus End of Period*
1933	$ 516	$156	$ 40	30.8	$ 53
1934	573	165	57	28.9	110
1935	782	249	90	31.9	78
1936	1,039	370	142	35.5	146
1937	1,291	378	100	29.2	165
1938	1,068	323	67	30.3	169
1939	1,322	412	118	31.2	239
1940	1,428	407	94	28.5	291
1941	2,104	604	146	28.7	386
1942	1,906	491	85	25.7	443
1943	1,980	476	76	24.0	505
1944	1,964	457	59	23.3	540
1945 to Sept. 29	1,423	293	10	20.6	537

for a unit of output had therefore increased. Likewise, prices for the raw materials had shown a tendency gradually to rise. With price ceilings on the finished product rigidly enforced, the company had been unable to maintain its prewar margin of profit.

With the prospective lifting of price ceilings, company officials anticipated higher prices for the company's products and a return to prewar profit margins. While the company's costs had increased, it was believed that the costs of competitors had increased at least proportionately. Consequently, the company's position within the industry seemed favorable.

In considering the company's financial needs in the immediate postwar period, the management was faced with many uncertainties. A major market would be the building industry. The executives were aware that a large deferred demand for building existed but were not confident that conditions were right to permit rapid expansion in the industry. The great increase in building costs might defer the beginning of a building boom. A similar situation existed in the furniture manufacturing industry, which was a large consumer of abrasives. Many furniture manufacturing companies had operated at low volume throughout the war years, and it was expected that demand for new furniture would be strong. This industry, however, would be influenced by the rate of construction of new homes. Its cost structure had also risen substantially during the war period. In 1945, numerous strikes were threatening in the metalworking industry, so that a considerable period of time might elapse before many of the large units, such as the automobile manufacturing companies, would get into full production.

In spite of the uncertainties, the management was convinced that a substantial sum of money should be spent in order to insure the company's position in the industry. The expansion of the company had thus far been financed principally from two sources—retained earnings and short-term bank borrowings. The company's banks had shown confidence in the management and had lent as much as $250,000 at 2% interest. The company had steadily made use of its lines of credit with the banks; notes payable usually were outstanding in amounts varying from $150,000 to $250,000. The treasurer believed that a type of capital more permanent than short-term bank loans would be desirable when the business developed as he hoped it would.

In addition to these financing needs, Mr. Sohier foresaw that in the neighborhood of $200,000 should be spent within a year to improve the plant and increase productive efficiency. Little equipment had been re-

Exhibit 2

GARNET ABRASIVE COMPANY, INC.

BALANCE SHEETS

(Dollar figures in thousands)

ASSETS		*Dec. 31 1942*		*Dec. 31 1943*		*Dec. 31 1944*		*Sept. 29 1945*
Cash		$ 122		$ 178		$ 233		$ 178
Accounts receivable (net)		150		122		103		109
Inventories:								
Finished goods		220		185		226		203
Work in process		248		205		168		180
Raw materials		166		262		205		300
Supplies		17		19		23		23
Total current assets		$ 923		$ 971		$ 958		$ 993
Fixed assets:								
Land		$ 3		$ 3		$ 3		$ 3
Buildings	$77		$ 84		$ 86		$ 86	
Less: Reserve for depreciation	13	64	16	68	17	69	19	67
Machinery and equipment	$ 221		$ 218		$ 239		$ 255	
Less: Reserve for depreciation	96	125	93	125	108	131	125	130
Total fixed assets		$ 192		$ 196		$ 203		$ 200
Prepaid expenses and other assets		$ 110		$ 106		$ 77		$ 85
Total assets		$1,225		$1,273		$1,238		$1,278

LIABILITIES				
Accounts payable	$ 30	$ 65	$ 42	$ 100
Notes payable—bank	233	200	166	166
Accrued wages	....	....	....	9
Reserve for taxes	92	67	56	28
Sundry reserves	16	27	27	32
Total current liabilities	$ 371	$ 359	$ 291	$ 335
Capital stock:				
Preferred, par $100, 7%	$ 245	$ 243	$ 241	$ 240
Common, par $5	138	138	138	138
Earned surplus	443	505	540	537
Capital surplus	28	28	28	28
Total liabilities	$1,225	$1,273	$1,238	$1,278

placed during the war, and the company's machinery was subject to unusual deterioration because of the nature of the manufacturing process. The abrasive grains penetrated all the moving parts of the machinery, with the result that the machines wore out rapidly. Depreciation charges and expenses for repairs were so high that these items had at times been questioned by the Bureau of Internal Revenue, although the amounts as stated had always been accepted after investigation. (See Exhibit 2 [pp. 86–87]). Most of the machines were designed by the plant engineer and built to order by machine shops in the vicinity.

The steady rise in labor costs which had taken place was, in the opinion of the management, a further reason to install new equipment that would be more efficient and automatic.

In addition to expenditures for new machinery, the company was faced with an outlay of about $55,000 for a new ventilating system. The State Board of Health was insisting that methods be devised to protect the workers against the abrasive dust. On the basis of experience the management was convinced that the dust produced in the manufacture of abrasives was not toxic or otherwise injurious to the employees' health. It appeared necessary, nevertheless, to comply with the requirements of the health board.

Thus, Mr. Sohier concluded that the need for funds amounted to at least $505,000, broken down as follows:

Replacement of short-term borrowings to meet working capital needs	$250,000
New machinery	200,000
New ventilating system	55,000
	$505,000

This estimate did not allow for additional working capital that might be needed if sales increased substantially.

The company did not prepare a detailed budget of cash receipts and expenditures, and the estimates of financial needs which Mr. Sohier used were therefore based principally upon his own knowledge of the company's requirements together with information gained from conversations with other executives of the company. In spite of some uncertainties regarding the amounts needed and the time the funds would be employed, Mr. Sohier was convinced that conditions were advantageous for obtaining longer term funds. He proceeded to discuss the problem with officers in his company's banks and to work out with them tentative plans for the financing.

The company's two principal banks expressed willingness to make

term loans to the company in the amount of $550,000 payable in installments from 1946 to 1950. During preliminary conversations with the bankers in July, 1945, the following provisions for a term loan agreement had been developed:

1. The principal amount would be $550,000.
2. The loan would be repaid in the following installments:

On or before January 1, 1946	$ 30,000
On or before January 1, 1947	75,000
On or before January 1, 1948	75,000
On or before January 1, 1949	110,000
On or before January 1, 1950	110,000
On or before October 1, 1950	150,000

3. The loan would be evidenced by two negotiable promissory notes, one in the amount of $400,000 to the larger of the two banks and one for $150,000 to the smaller bank.

4. Payments would be made pro rata on the two notes. The company would have the option of paying semiannual instead of annual installments. All or any part of the loan might be paid in advance of the foregoing schedule without penalty to the company unless the company borrowed from others for the purpose of paying the loans, when the bank would require a premium of 1% of the principal amount so paid.

5. Interest at the annual rate of 3% would be paid quarterly at the end of each quarter.

6. The company would agree that, during the life of the loans, net working capital would not be reduced below $750,000, except that after each payment of $75,000 the requirements for minimum net working capital would be reduced by $35,000 and upon payment of each $110,000 the requirement would be reduced by $45,000. Net working capital would be defined as the excess of current assets over current liabilities and would be determined in accordance with generally accepted accounting practices. Current liabilities would include all obligations due within 12 months.

7. The company would agree that its total debt would at no time exceed $850,000; in the calculation of these liabilities all accrued taxes were to be included.

8. The company would agree to pay no dividends and would retire no shares of capital stock except that four quarterly dividends might be paid on the 7% cumulative preferred stock annually.

9. The company would agree not to sell or pledge any assets in excess of $25,000 without written permission from the banks. The company would agree not to borrow additional sums and would not spend over $350,000 on its plant without the permission of the banks. Salaries to the three principal officers were not to exceed $75,000 in total without permission of the banks. The company would agree to submit annual audit reports within three months of the end of each fiscal year and to supply unaudited quarterly balance sheets and operating statements. The company would further agree not to guarantee the debts of any

other organization or individual or to make any advances in excess of $25,000. The company would also agree not to merge, consolidate, or sell its business without permission of the banks.

10. Certain events would be considered to constitute default on the loan. These included an entire change of management through the sale of stock, in which event the bank would be permitted to call the loan 60 days after it notified the company of its intention. The notes would become payable on demand in event of bankruptcy, receivership, or assignment for benefit of creditors or upon institution of any insolvency proceedings or if the company defaulted for 30 days on principal or interest or in any other covenant of the loan agreement.

Adanac Packaging Machine Company

In January, 1947, at the request of the board of directors of the Adanac Packaging Machine Company, Mr. H. S. Cox, the treasurer, had discussed the advisability of shifting the company's short-term bank loan to a term loan basis with Mr. Austin, a loan officer of the Industrial Bank. The interview is described more fully below. As a result of his talk with Mr. Austin, Mr. Cox was at work on pro forma statements to show the effect of anticipated events in the year ending December 31, 1947. Also, since he had found Mr. Austin reluctant to enter a term loan arrangement, he was considering what to recommend to the directors with reference to the details of credit arrangements with the bank.

The Adanac Packaging Machine Company was formed in 1910 by the current management. It had grown in large part by the reinvestment of earnings, although liberal dividends had also been paid. The company had developed outstanding packaging and labeling machines, which it supplied to the leading companies in the branded food industries.

The restricted supply of these units during the war years, coupled with expansion of sales in the food industry, caused an unprecedented postwar demand for Adanac Packaging Machine Company products. Although shipments increased from $135,534 in January, 1946, to $740,314 in December, 1946, the balance of unfilled orders increased from $7,353,921 to $13,176,615 over this same period of time. The directors of the company felt that demand of this size was not destined to last for many years. Therefore, they were reluctant to increase the permanent capital of the business. They also wished to stop the three-shift manufacturing schedule that had been in effect.

The order contracts were not cancelable and in addition carried a clause to the effect that quoted prices were subject to upward revision to cover any increases in costs that should occur before the time of shipment.

The management felt that it was essential that this demand be satisfied as quickly as possible in order not to encourage the development of competition. Therefore, it was decided to subcontract about $4,000,000 out of a total of about $8,000,000 of forecasted sales for the year 1947 in spite of the lowered profit margins that would result on these items. It was estimated this policy would increase cost of the subcontracted products as delivered to the Adanac Packaging Machine Company about 9% over recently experienced factory costs in the Adanac plant. However, the management decided not to increase prices because of this increase in costs.

Arrangements had been completed with four manufacturing concerns to handle this subcontracted work. One concern had large cash reserves and required no financing. On the other hand, it was estimated that the three smaller subcontractors would require advances totaling $190,000 to finance their inventory and that these advances would continue until the subcontracting program was completed.

Even with the arrangements described, the company anticipated the continuance of a large volume of activity for well over a year. To assure its completion of the forecasted shipping schedule, the company embarked upon a further building and renovation program, the cost of which was not expected to exceed $625,000. At the end of 1946, $50,000 of this $625,000 had already been expended, and the balance was committed for 1947 work.

Since incorporation the company had enjoyed cordial relations with a very large bank which was able to lend many times the amounts which might be required by Adanac. The bank had always been very willing to give needed assistance to the company and had indicated its complete confidence in the management.

In January, 1947, the Adanac company had been using bank credit for over a year. Mr. H. S. Cox, treasurer of the company, realized that the expansion program and the working capital needs of 1947 would require the company to obtain more funds. When the situation was discussed by the board of directors, it was agreed that temporary financing should be sought from the bank.

Whether this financing should be done on a short-term basis, as then was the case, or on a term basis or perhaps in part on a term and part on a short-term basis was a subject for considerable discussion. Mr. Alfred Davidson, general manager of the company, advocated that the bank loan be made a term loan. He recalled rather vividly the recession period

following World War I, when many banks refused to renew short-term loans. Some companies were forced into bankruptcy, while others had to liquidate their inventories at distress prices. Mr. Davidson argued that a term loan, being a definite arrangement, would prevent any such sudden action. The other directors, after hearing Mr. Davidson's argument, agreed with him and asked Mr. Cox to open negotiations with the company's bank, the Industrial National Bank, with the view of securing a tentative term loan agreement.

The next day Mr. Cox discussed with Mr. Austin, loan officer of the Industrial National Bank, the plans for the Adanac Packaging Machine Company. Mr. Austin first questioned the profitability of the coming year's operations. Mr. Cox replied that he expected the proportion of manufacturing costs to sales in the Adanac plant to remain about the same in 1947 as during 1946. On the other hand, the "cost of sales" of the subcontracted work was expected to be about 9% higher. Overhead expense was expected to increase by 30% over the total of the previous year as a result of additional selling, clerical, and shipping costs necessitated by the increased sales. Although the income tax obligations of the company had been confused in recent years because of such procedures as renegotiation, it was thought that those uncertainties were past and that the company would be subject to the usual rate of 38% in the coming fiscal year. On these assumptions, taxes would be about $236,000, and net profit after taxes $386,000. These figures were, of course, after depreciation, which would be about $100,000.

Mr. Cox had said that he could not make a monthly cash budget with sufficient accuracy to be useful. Moreover, with the large backlog of orders, seasonal variations in shipments would not have to be considered. He did agree, however, to prepare a pro forma balance sheet as at December 31, 1947, to show Mr. Austin the likely effect of the expansion of the Adanac plant and of the subcontracting program.

On returning to his office and reviewing the December 31, 1946, balance sheet with reference to changes likely to occur during the forthcoming year, Mr. Cox decided that he should plan to set his cash balance at $625,000 to safeguard against any lag that might have to be financed between the time that payments were received from customers on products manufactured by subcontractors and the time that payments had to be made to subcontractors for this same machinery. This cash would be in addition to the $190,000 advance to the subcontractors.

Mr. Cox made a rough forecast that receivables might reach a peak

of $1,125,000, of which $125,000 would be offset by an accounts payable item to the subcontractors. He also thought that a further increase of $375,000 might occur in the inventory figures. U.S. government bonds were to be disposed of in the next few months to offset in part the cost of the new facilities.

Mr. Cox was doubtful just how far he could expand the accounts payable but thought that probably those on account of goods made in the Adanac plant would remain at their current level. The tax liability would grow during the year to the amount of the calculated tax for the fiscal year.

Dividends had been paid during 1946 on the preferred shares at the rate of 6% ($12,000) and on the common at $8.15 a share (about $120,000). Mr. Cox knew that the major stockholders, who were also among the management, would be very reluctant to reduce the common dividends and might desire larger ones if justified by earnings. On this point, Mr. Austin had said that it would be better to defer action on raising the dividends until after the 1947 fiscal year ended, when operating results would be known. Even if they proved satisfactory, Mr. Austin had said that it would be desirable to discuss the matter with the bank before taking action to increase existing rates.

During the interview with Mr. Austin, Mr. Cox had switched the topic of conversation to the bank's attitude towards a term loan. Mr. Austin had expressed reluctance to enter into a term loan agreement. He said he was willing to carry the company along on the present basis of 2½% unsecured notes with six-month maturities, so long as conditions remained favorable to the loan and interest rates did not stiffen. In fact, the bank would be pleased to finance the whole program on this basis.

When Mr. Cox pressed Mr. Austin as to why the bank was reluctant to put the loan on a term basis, Mr. Austin replied that he thought Mr. Cox would not find much advantage in it. In the first place, the rate of interest would be 3% to 3½%, probably the latter. The bank would require the company to reduce the loan beginning at the end of the second or third year so as to pay it off by the end of 1954. Prepayments, of course, would be acceptable without penalty.

Mr. Austin took pains to remind Mr. Cox that such a term loan agreement would incorporate a proviso requiring either that net working capital be kept at a conservative amount or else that a suitable current ratio be maintained. There would also be included a limit on the

maximum current and noncurrent borrowings as well as a negative pledge clause in regard to all assets. In addition, payment of dividends and retirement of capital stock would be limited to not more than the amount of the earnings available since the date of the loan but within the limits on working capital that he had mentioned. Probably, Mr. Austin asserted, the bank would wish to limit increases in the gross amount that could be paid out in executive salaries. If any of these conditions should be violated, the whole term loan would be automatically due in 60 days. Summing up, Mr. Austin said that the purpose of all such restrictions was to preserve the company's financial position at the level it would reach shortly after the loan was extended and the proceeds of the loan had been put to use.

Mr. Austin summarized his position by saying that he saw nothing to be gained by asking his bank to consider a term loan when it already had expressed willingness to arrange financing on an unsecured basis to any reasonable amount. But as the interview concluded, he said that he would be glad to discuss the matter further. Mr. Cox returned to his office and commenced to prepare the pro forma statements he had promised Mr. Austin. He was confused as to what stand he should take before the board of directors on the question of the term loan as against the existing arrangement.

Exhibit 1 shows the Adanac company's balance sheets for 1944, 1945, and 1946. Exhibit 2 shows the operating statements for these years, and Exhibit 3 the operating record from 1936 to 1946.

Exhibit 1

ADANAC PACKAGING MACHINE COMPANY

BALANCE SHEETS

(Dollar figures in thousands)

ASSETS

	Dec. 31 1944	Dec. 31 1945	Dec. 31 1946
Cash	$ 921	$ 603	$ 464
Notes and accounts receivable, net	207	518	1,011
Inventories	803	1,060	1,676
U.S. government bonds	726	819	516
Postwar tax refund, payable in 1945	...	81	...
Total current assets	$2,657	$3,081	$3,667
Fixed assets, net	352	477	825
Deferred charges and prepaid expenses	59	88	75
Goodwill, patents, trademarks	1,000	973	952
Patterns and drawings	28	41	63
Postwar excess profit tax refund	28	...	...
Total assets	$4,124	$4,660	$5,582

LIABILITIES

	Dec. 31 1944	Dec. 31 1945	Dec. 31 1946
Notes payable—banks	$ ...	$ 500	$1,125
Accounts payable and accruals	529	565	764
Reserves for taxes—accruals	43	98	110
Due to U.S. government	77	...	...
Total current liabilities	$ 649	$1,163	$1,999
Capital stock—6% preferred	201	201	200
Common, par $100	1,472	1,472	1,472
Surplus	1,802	1,824	1,911
Total liabilities	$4,124	$4,660	$5,582

Exhibit 2

ADANAC PACKAGING MACHINE COMPANY

OPERATING STATEMENTS

(Dollar figures in thousands)

	1944	1945	1946
Sales, net	$7,928	$2,747	$4,354
Cost of sales*	6,583	2,097	3,481
Gross profit	$1,345	$ 650	$ 873
Operating expenses	653	605	595
Profit from operations	$ 692	$ 45	$ 278
Other income, net†	94	78	85
Profit before taxes	$ 786	$ 123	$ 363
Provision for taxes	472	50	144
Refund of prior years' excess profits tax	...	81	...
Net profit	$ 314	$ 154	$ 219
Dividends paid	177	132	132
* Includes amortization and depreciation	$130	$136	$95
† Includes royalties	73	54	40

Exhibit 3

ADANAC PACKAGING MACHINE COMPANY

OPERATING RECORD

(Dollar figures in thousands)

Year	*Sales*	*Taxes on Income*	*Net Profits*	*Dividends*	*Earnings Retained*
1936	$1,546	$ 30	$163	$ 13	$ 150
1937	2,501	56	302	193	110
1938	1,649	16	83	102	19[d]
1939	2,544	93	407	267	140
1940	2,575	72	304	177	127
1941	2,783	123	338	177	161
1942	3,785	701	316	177	139
1943	4,064	594	289	177	112
1944	7,928	472	314	177	137
1945	2,747	50	154*	132	22
1946	4,354	144	219	132	87

* Includes tax refund for prior years, $81,000.
[d] Deficit.

Scott Laundry Company, Inc.

On June 1, 1944, James Scott, treasurer of the Scott Laundry Company, Inc., read in the morning newspaper that the laundry plant of his company would soon be released from the control of the United States Army after a year during which the facilities had been operated by the Army. Upon inquiring from the responsible officials, Mr. Scott received confirmation of this report. He realized that the company was faced with urgent problems of re-establishing its civilian business and of financing its operations.

Francis H. Scott had founded the Scott Laundry Company in Newark, New Jersey, in 1910. Mr. Scott was in his middle seventies in 1944 and, though he retained the office of president, the active management was in the hands of his two sons, Francis Scott, Jr., vice-president (in charge of operations), and James Scott, treasurer and secretary. The two sons had joined their father in the enterprise in the early 1920's.

During the 11 years from 1931 through 1941, the volume of business done by the company had grown steadily, net sales increasing from \$206,600 in 1931 to \$445,308 in 1941. Substantial profits had been earned, ranging from a low of \$19,900 after taxes in 1931 to a high of \$40,600 after taxes in 1939. A large portion of the profits was paid out in dividends. The capital stock of the company, all of which was owned by members of the Scott family, had not been increased during this period.

James Scott attributed the steady growth of the business principally to a merchandising plan which he had devised in 1933, a depression year. At that time he found that the size of an average family laundry in the residential area of Newark and neighboring communities served by the company was about 20 pounds a week but that, except for the "wet wash" service, the laundry bundles typically were well below this weight, an indication that housewives were not sending out the entire

household laundry. He also found that the size of the bundles tended to decrease directly in proportion to any increase in the price charged for the particular service. Up to that time, the company had followed the customary practice in the industry and charged at varying rates; for example, from 7 cents to 20 cents a pound according to the type of finish for the particular article such as "rough dry," "flat," or specially finished as in the case of shirts and blouses.

As a result of his studies, Mr. Scott became convinced that the method of pricing at different rates deterred housewives from sending out all the family laundry. To correct this situation Mr. Scott wished to offer his customers a service at the lowest possible basic price a pound that would permit the company to operate at a profit. Such a price would, he thought, prevent the "splitting of the bundle" and insure a normal ratio in each bundle between household articles that required only a rough dry or flat finish and wearing apparel that required a more complicated process of finishing. After some experimentation Mr. Scott therefore instituted what he called the "family bundle," with a minimum charge of $2 for 20 pounds and a charge of 10 cents for each additional pound regardless of the type of finish required by the various articles included in the bundle. The resulting major increase in volume came from the larger unit of sale to those customers who theretofore had used the semifinished services.

Mr. Scott was proud of the fact that the company's volume expanded steadily during the depression years. Furthermore, he believed that upon the re-establishment of the business after the plant was returned by the Army the same principle of volume service at low prices should be continued, although he recognized that costs were higher and that the price of the family bundle would have to be increased to some extent.

By 1942 the continued expansion in business had necessitated major additions to the company's buildings and an expenditure of $50,000 for new equipment. In consequence, the company had to borrow a relatively large amount, $75,000, from its bank, the Seaboard Trust Company. Even this amount had not been sufficient to permit the company to pay all its trade creditors promptly. By the time the plant was commandeered in the spring of 1943, there were a number of overdue trade accounts payable while a substantial sum also remained owing to the bank.

At the time the Army took over the plant Mr. Scott had an appraisal of the property made in order to determine a basis for the rental to be paid by the Army. The appraisal indicated that the plant should be val-

ued at $275,000 on the basis of reproduction cost new less depreciation. The appraisal company further indicated that the Army's payment should take into account costs estimated at $120,000 which had been incurred in training the company's staff and in building up a customer clientele, since it was anticipated that these costs would have to be re-incurred in re-establishing the business after the plant was returned from Army operation. The appraisal company considered 15% per annum a fair rate of rental on the fixed assets and 33⅓% per annum as the proper rate at which to write off the costs of building up the company's staff and customers. On this basis the appraisal company arrived at $81,250 as the estimated fair annual rental for the property. This estimate, however, was not accepted by the government and an annual rate of $40,000 was established. The management was forced, under a court order, to turn over the facilities on the Army's terms. Mr. Scott planned to go to the United States Court of Claims for additional compensation.

The rental during the year 1943 was not sufficient to liquidate any large part of the liabilities created by the expansion in 1942, as will be seen from the March 31, 1944, balance sheet shown in Exhibit 1.

The mortgages for $53,000 and $15,000 held by the bank were secured by all the plant and equipment used in the enterprise. In addition, insurance policies with a cash surrender value of $41,638 were pledged as security for the bank loan. The policies insured the lives of each of the two Scott sons for $75,000; their estates were named as beneficiaries. The notes and loans payable, totaling $13,176, included about $3,000 due to trade creditors and $10,000 advanced from personal funds of the Scott family. In order to make these advances the members of the Scott family had mortgaged their homes in 1942.

The debenture sinking fund certificates, totaling $21,800, were held by trade creditors. The certificates had been issued to certain trade creditors in 1943 before the Army took over in settlement of overdue accounts payable. The certificates bore a 5% noncumulative interest rate, payable only if earned, and were convertible into preferred stock, at the holder's option, after five years. Under their terms the company agreed to set aside 75% of net income for payment of the principal of the certificates. The holders agreed to subordinate the certificates to the mortgage notes which were held by the bank.

Early in 1942 the company had experienced difficulty in retaining its personnel because of the high wages paid by war plants in the vicinity. In spite of increases in piece rates, turnover in the labor force became

as high as 200% in a three months' period in 1942. Price controls made it impossible to increase the charges for laundry so that the margin of profit had narrowed as shown in Exhibit 2. By the end of the year of operation by the Army the labor force was almost completely new and the piece-rate method of compensation had been replaced by an hourly wage at a high rate. The efficiency of the labor force, moreover, had decreased greatly because of the irregularity of the work. Consequently, Mr. Scott believed that the selection of a skilled and efficient labor force was one of the key problems to be faced.

Mr. Scott realized that a large volume of profitable civilian business could not be regained immediately because of the shortage of labor, delivery equipment, and trained route men, but he counted on three sources of business to enable him to resume operations on a profitable basis. A chain of retail laundry stores which for the most part had been closed during the war wanted to reopen if he would take their laundry and cleaning work. Also, near-by summer hotels were opening and these old customers could be counted upon for a substantial volume. In addition he expected the company's own store located in the laundry to produce a good volume of business as it was situated on a main route from Newark to several populous suburbs. For some months, at least, this store would have a further advantage in that the laundry could finish work several days more quickly than its competitors. Mr. Scott estimated that these three sources of business would enable him to open his plant and employ all the available good help. He expected that sales would total approximately $5,000 per week, made up of $2,150 to the laundry chain, $1,350 to summer hotels, and $1,500 in the company's store.

While it was impossible to get recent operating figures from the Army, Mr. Scott had prepared figures from the annual statistics of the American Institute of Laundering. He realized that his firm was not entirely typical but thought that the computation, shown in Exhibit 3, might be a guide.

It was evident to Mr. Scott that additional cash would be necessary before the company could resume operations. He estimated that at least $7,000 would be necessary for working capital and an additional $10,000 would be desirable for purchasing laundry supplies which the Army had accumulated and which could be acquired at advantageous prices. He therefore decided to ask his bank to lend an additional $17,000 for these purchases.

Mr. Scott had some misgiving about the bank's willingness to in-

Exhibit 1

SCOTT LAUNDRY COMPANY, INC.

BALANCE SHEET

March 31, 1944

ASSETS

Cash		$ 3,113
Accounts receivable		1,566
Current assets		$ 4,679
Land and buildings	$146,292	
Machinery and equipment	207,952	
	$354,244	
Allowance for depreciation:		
Buildings	53,834	
Machinery and equipment	121,372	179,038
Cash surrender value of life insurance (pledged under mortgage note)		41,638
Investments (treasury stock)		7,300
Prepaid items		692
Total assets		$233,347

LIABILITIES

Notes payable	$ 6,176
Loans payable	7,000
Accrued expenses	225
Current liabilities	$ 13,401
Advances from officers	5,950
Reserve for taxes	1,009
Reserve for compensation losses	4,551
Mortgages payable to banks:	
Real estate	53,000
Chattel	15,000
Debenture sinking fund certificates	21,800
7% cumulative preferred stock	30,000
Common stock	20,000
Surplus	68,636
Total liabilities and net worth	$233,347

crease its loan. In the early years of the company's history the relationship with the bank had been cordial, but since about 1925 Mr. Scott had sensed a changed attitude. At that time the controlling stock of the bank had been purchased by a larger bank in Newark and management policies had been determined by the directors of the larger institution. In Mr. Scott's opinion the loan officer had become more conservative in his judgment of loan risks and less aggressive in searching for new loans. For example, the loan officer had never inquired whether the bank

Exhibit 2

SCOTT LAUNDRY COMPANY, INC.

INCOME STATEMENTS

	1941	1942
Net sales	$445,308	$453,176
Productive labor	$ 97,645	$152,947
Productive supplies	44,563	43,788
Power	33,832	33,242
Plant overhead	62,772	61,678
Laundry operating costs	$238,812	$291,655
Collection and delivery	87,229	71,200
Sales promotion	13,247	13,039
Executive salaries	22,373	21,983
Office and administrative	33,515	32,931
Total costs	$395,176	$430,808
Net profit before taxes	50,132	22,368
Income taxes	15,220	13,637
Net profit after taxes	$ 34,912	$ 8,731

Exhibit 3

SCOTT LAUNDRY COMPANY, INC.

ESTIMATED INCOME STATEMENT FOR RENEWED OPERATIONS

Net sales	$250,000
Productive labor	$ 85,700
Productive supplies	22,500
Power	7,500
Plant overhead	32,400
Laundry operating costs	$148,100
Collection and delivery	44,175
Sales promotion	8,300
Executive salaries	8,650
Office and administrative	18,100
Total costs	$227,325
Net profit before taxes	$ 22,675

might finance any purchases of new equipment although the rates charged by the finance companies for such financing were considerably higher than the bank received on its regular commercial loans. The large amount of collateral which had been demanded to secure the existing loan was, in Mr. Scott's opinion, further evidence of the loan officer's conservative attitude.

Mr. Scott recognized also that the prospects for an additional loan

might be reduced by the company's failure to repay the existing loan as rapidly as was originally contemplated. When the loan was arranged monthly payments of $1,000 were agreed upon, but the Army's rental payments had been too small to allow Mr. Scott to continue payments at that rate, and the monthly payments had been reduced to $500.

Mr. Scott had for many years submitted financial statements to the bank at the end of the company's fiscal years and had periodically discussed the company's affairs with the loan officer. He had explained to the loan officer the reasons why it was not possible to reduce the loan more rapidly while the Army operated the plant and had given him a copy of the appraiser's report at the same time. Mr. Scott believed that the company's earning record over a period of years was adequate evidence of the management's ability. Moreover, his reputation as a leader in the community was well known to the bank, since he had held a number of prominent positions locally, including the presidency of the Newark Chamber of Commerce.

In accordance with his decision to seek aid from his bank, Mr. Scott called at the bank, explained the reasons for the company's need to increase the loan, and outlined in general terms his plans. After listening for an hour, the loan officer said he regretted that he could not agree to increase the loan and suggested that Mr. Scott find sufficient trade credit to permit resumption of operations.

The brusque manner of the loan officer at the Seaboard Trust Company came as quite a surprise to Mr. Scott. Almost before he left the bank, he decided to transfer his banking business to another institution as soon as possible. That evening he talked the matter over briefly with a neighbor, who was a teller in the Market Street National Bank, another bank in Newark. This man said that his bank was interested in expanding its business with local concerns and that he would ask one of the officers to get in touch with Mr. Scott.

During the following morning, Mr. Scott received a telephone call from Mr. Bernstein, assistant cashier of the Market Street National Bank, who said that he had had an outline of the situation from the teller, that it "sounded like a loan," and that he was anxious to see Mr. Scott. An appointment was made for the following afternoon. As the conversation closed, Mr. Bernstein suggested to Mr. Scott that he should bring with him some figures and "anything else of interest to the credit department" for the folder that Mr. Bernstein would set up on the Scott Laundry Company.

Haward Manufacturing Company, Inc.

In July, 1940, Mr. Ralph Haward, treasurer of the Haward Manufacturing Company, was considering how to finance the forthcoming season. The company was a well-known manufacturer of high-grade children's heavy winter outerwear. It had been in the hands of the Haward family for over 40 years. Once amply financed, the company had had a series of unfortunate years since 1936 which had made it necessary for it to secure financial aid to continue in business. The 1939 season had been financed with great difficulty.

The manufacturing operations of the Haward Manufacturing Company, Inc., were highly seasonal. Active work usually commenced in May or June and continued until November or December. In the late spring the company planned the financing for the forthcoming season. The company's customers, large and reliable retail organizations, would not accept delivery or pay for the merchandise until early fall. They were willing, however, to place their orders during the spring and summer if the Haward Manufacturing Company would undertake to meet lowered prices if offered by competitors at the time of delivery. Terms of sale were 2%, 10 days, E.O.M. for the larger sizes and 8%, 10 days, E.O.M. for the infant sizes with all shipments made before September 1, dated as of that date. These discounts usually averaged 5% of sales.

The financing problem created by production, which began during the late spring, had been met for many years by the willingness of the fabric suppliers to bill spring and early summer shipments of their goods "60 days July 1." This gave up to four months' credit to the company on its purchases. The principal cash requirement of the production period was, therefore, for the payrolls. This need had been financed without difficulty until 1937.

The financial difficulties which culminated in 1939 and 1940 arose as follows:

During 1936 and the early part of 1937 the company erected a new building and made improvements on buildings already owned and occupied. These expenditures amounted to about $22,000. When the work was about to begin, the company's bank had been asked to make a long-term loan secured by a mortgage on the property. This would increase the mortgage loan made by the bank when the property had been purchased some years previously. The officer interviewed had seemed favorably impressed with the loan request but suggested that the improvements be completed first and then the loan be arranged. With this informal understanding, the construction was completed in the summer of 1937. By this time, however, business conditions in the garment industry were unfavorable, and the bank refused to increase the mortgage loan.

Owing to mild weather, the fall of 1936 had not proved a good selling season for winter clothing. The retail trade, therefore, had a large carry-over of such merchandise to the 1937–1938 season. In the spring and summer of 1937, when the Haward company attempted to sell its fall lines, it discovered that most stores had on hand a heavy inventory. It was also learned that sales resistance to Haward products was very high, as many garments had proven unsatisfactory during the past season because of hidden defects in the fabric used. The retailers had had to take back a number of the garments from their customers. This situation necessitated Haward's reimbursing the retailers for the goods returned. In turn, the Haward Manufacturing Company sued the mill which supplied the inferior fabric, but as of July, 1940, settlement had not yet been made. The expense of indemnifying the retailers proved to be small, but the effect of this poor merchandise on the good will of the concern was very damaging. Lagging sales in the fall of 1937 resulted in an inventory carry-over into 1938 of $42,000 as compared to the previous year's carry-over of $18,000.

When it became apparent that the Haward company would be forced to carry the large inventory into 1938, it was realized that the accounts payable could not be liquidated when due. Mr. Haward was able to persuade the majority of the creditors to defer their claims by promising payment in full within a year. However, difficulty was encountered when one principal creditor was asked to consent to deferment. The concern itself appeared to be willing to defer the amount

owing to it, but the insurance company which guaranteed its accounts receivable asked that the matter be cleared up immediately and agreed to settle for 25% of the amount owing. Even to make this settlement, the Haward Manufacturing Company was forced to sell to the government[1] $60,000 cost value of inventory for about $14,500. This action depleted still further the company's resources, leaving it with $32,400 in deferred claims to be settled.

The situation became more complicated when the problem of financing the 1938 season was faced. The credit losses of fabric suppliers had been so widespread during the previous year that they refused to grant credit beyond 30 days. Thus the Haward company had to provide funds in advance of collections not only for payrolls but also to purchase fabric. A 5%, $6,000 bank loan was arranged, but the principal stockholders pledged their personal securities as collateral for this loan. This loan was paid in the fall, but inventory figures were kept very low.

During the next season, 1939–1940, the company had very little liquid funds to carry on the business. Operations were carried on in a hand-to-mouth manner. The bank advanced $12,000; yet it was necessary to arrange a 5%, $2,400 loan on the personal endorsement of the principals with a small co-operative loan agency. This loan was to be reduced by $200 per month. Funds were so limited during this period that the management decided not to do the usual sales promotion work. The low sales experienced in 1939 were thought to be due in part to this policy.

But, during the fall of 1939 and spring of 1940, the company was able to promote its line in an unusual way. A revolving type of display was placed in front of seats placed for rest purposes at the New York World's Fair. This display pointed out the desirable features of the Haward products. Order blanks were available so that onlookers could place orders on the location. The company planned to fill these orders through a retailer in the area where the customer lived, and thus establish new retailer contacts. The cost of this display, $1,100, was paid in advance out of the personal funds of Mr. Haward. The $2,000 cost of printing the necessary literature to go along with the display was arranged by friends of Mr. Haward on his personal guarantee.

By July, 1940, toward the end of the usual selling season, Haward

[1] Unsettled conditions were so general in the garment manufacturing industry that the government purchased some $50,000,000 of merchandise for $15,000,000 for relief purposes.

Exhibit 1

HAWARD MANUFACTURING COMPANY, INC.

PROJECTED SCHEDULE OF RECEIPTS AND PAYMENTS

August, 1940—January, 1941

	Aug.	*Sept.*	*Oct.*	*Nov.*	*Dec.*	*Jan.*
Number of garments manufactured*	1,200	3,600	3,600	3,600	2,400	.....
Accounts receivable collections:						
Prior month	....	.....	$ 8,400†	$ 8,400	$ 8,400	$16,800‡
Second prior month	....	.....	8,400†	16,800	16,800	16,800
Discount on sales	....	.....	(840)	(1,380)	(1,380)	(1,680)
Total receipts	....	.....	$15,960	$23,820	$23,820	$31,920
Payments for material	....	$19,740§	.....	$14,100	.....	.....
Payroll	$1,620‖	4,860	$ 4,860	4,860	$ 3,240	.....
Administrative	2,400	4,200	3,600	3,000	1,200	.....
Total payments	$4,020	$28,800	$ 8,460	$21,960	$ 4,440	.....
Deficit or surplus of cash	($4,020)	($28,800)	$ 7,500	$ 1,860	$19,380	$31,920
Cumulative (deficit) or surplus of cash	($4,020)	($32,820)	($25,320)	($23,460)	($ 4,080)	$27,840

Assumptions:

* Garments would be manufactured as on the above schedule.

† Assume all of August production and one-third of September production billed before September 30, making it eligible for payment in October.

‡ December production shipped by December 15 and billed before December 31.

§ Fabric would be delivered in August for 8,400 garments at $2.35, or $19,740. Terms would be n/30, therefore payable in September. Fabric delivered in October for November and December production and paid for in November.

‖ Payroll calculated on 1,200 garments at $1.35. Similarly for other months.

Manufacturing Company, Inc., had $90,000 sales value in firm orders at good prices from large and reliable retailers which were listed by the credit agencies as AA1 accounts. Sufficient orders were now on hand for about four months' normal operation. The war in Europe had been going on for 10 months, and as a consequence economic conditions in the United States were quite buoyant. The management of Haward Manufacturing Company was confident that conditions now looked better for the company than they had in the past several years. They felt that the $90,000 orders already on the books gave assurance of a reasonably profitable season.

The management had kept complete records of the cost of making and selling each type of garment. The accountant had estimated the cost per garment for the fall of 1940 as follows:

Material cost (goods in style for 1940–1941 season)	$2.35
Direct labor	1.35
Administrative and selling	1.05
Total	$4.75
Average selling price	7.00
	$2.25
5% selling discount	0.35
Profit per unit	$1.90

He also made up a projected statement of cash receipts and payments for the season, which is shown in Exhibit 1 (p. 108). It does not include the possible receipts and disbursements related to the existing working capital position, and it excludes the salaries of the Haward brothers, who agreed to defer them until after the end of December. Exhibits 2 and 3 present recent financial statements of the company.

Toward the end of July, 1940, the company had a negative working capital position as shown in Exhibit 2. While the balance sheet valuation of the machinery was less than $6,000, it had been estimated that it was worth $24,000, with a quick sale value of $15,000. The buildings and real estate were carried on the balance sheet at $31,000 but had an appraised value for real estate taxation purposes of $48,000. The company still had a mortgage of $5,280 on the property. In spite of the apparent surplus mortgageable value that existed in this property, because of the great amount of loft space available at very reasonable rates in the city where the Haward Manufacturing Company, Inc., was located, it was impossible to secure funds by further mortgaging the property.

The fabric used by the company was of the highest grade and was considered a staple item. Before it was cut, it probably had a quick resale

Exhibit 2

HAWARD MANUFACTURING COMPANY, INC.

BALANCE SHEET AS OF DECEMBER 31, 1939
AND WORKING CAPITAL POSITION, JULY 25, 1940

ASSETS

		December 31 1939	July 25 1940
Current assets:			
Cash		$ 3,982	$ 654
Accounts receivable	$ 9,924		
Less: Reserve	164	9,760	2,600
Inventories:			
Finished and in process	$ 3,953		1,641
Raw materials	7,818		....
Trimmings	2,984	14,755	....
Investments (pledged)		9,745	9,745
Total current assets		$38,242	$14,640
Furniture, fixtures, and machinery	$ 8,497		
Less: Depreciation	2,159	6,338	
Land and buildings	$33,816		
Less: Depreciation	2,430	31,386	
Other assets		1,218	
Total assets		$77,184	

LIABILITIES

Current liabilities:		
Accounts payable—current	$ 8,068	$ 3,052
Notes payable—bank, secured	12,000	12,000
Notes payable—trade	2,400	500
Co-operative credit agency	1,400	....
Payroll and commissions	358	....
Total current liabilities	$24,226	$15,552
Mortgage payable	5,280	
Owing officers for salaries, etc.	1,484	
Federal income tax	....	
Capital stock	48,840	
Surplus	2,646[d]	
Total liabilities	$77,184	

[d] Deficit.

value of 90% of its current market. The cloth could be purchased on a hand-to-mouth basis, but substantial savings, perhaps as high as 8%, could be gained by making large quantity purchases. In making up his cash budget for the fall of 1940, Mr. Haward assumed large-scale purchases. Once the fabric was in the plant it took about three to four weeks to manufacture it into garments and to ship it out.

Exhibit 3

HAWARD MANUFACTURING COMPANY, INC.

INCOME STATEMENTS

	1938		1939	
Gross sales	$144,641		$102,415	
Less: Returns	15,937	$128,704	8,110	$94,305
Cost of sales:				
Material cost	$ 90,300		$ 49,938	
Labor	20,354		18,743	
Factory expense	1,408		1,668	
Freight and carting	1,228	113,290	846	71,195
Gross profit		$ 15,414		$23,110
Overhead expenses*		32,684		26,652
		$ 17,270[d]		$ 3,542[d]
Other income		676		600
Sales discount, etc.		6,906[d]		7,764[d]
Net profit for period		$ 23,500[d]		$10,706[d]
Beginning surplus		1,558		8,060
Donated surplus		14,212		....
Gain from settlement of accounts payable		15,790		....
Ending surplus		$ 8,060		$ 2,646[d]

* Includes: Salaries of 3 Haward brothers .... $12,216 .... $10,308
Depreciation charged ....

[d] Deficit.

The management had delayed putting into production the orders that had been secured through the World's Fair because of the lack of funds. The chief owners had no further personal assets that they felt they could risk in the business and some of them were interested in freeing the collateral that they had provided.

The company was facing a crucial period, but Mr. Haward was sure that it could be put on a successful basis again if only short-term financing could be obtained to handle the $90,000 of orders that had been secured.

Mr. Haward was not deeply concerned over his own welfare as far as the future of the company was concerned. He was confident that if his efforts to put this concern on a profitable basis were not successful he could always secure employment which would be as remunerative as this company had been to him in the past. However, he did feel that he had responsibilities toward his two brothers who were in the company and who were mainly concerned with the production aspects of the business.

PART 2

FINANCING LONG-RUN NEEDS

Slater Quarry Corporation

In the fall of 1935, Mr. W. B. Slater, the owner of a fairly large New England farm, discovered by accident that a wide vein of slate, apparently of excellent quality, ran across a portion of his farm which he had always regarded as barren and of little value. After some preliminary inquiries with regard to the market demand for high quality slate and to the existing sources of supply, he became very much interested in the possibility of opening a quarry on his property and extracting, processing, and marketing the slate. He realized that this enterprise would require financing in an amount substantially in excess of his own resources, but he was confident that the necessary financing could be obtained if he was able to make a sufficiently favorable showing with regard to the prospects of the enterprise.

Mr. Slater had a few thousand dollars of savings which he drew on rather heavily for the expenditures which appeared to be necessary to demonstrate the commercial practicability of his project. The major expense was incurred in testing the extent and quality of the slate deposit by diamond drilling. The report on the test drillings indicated considerable amounts of heavy slate free of pyrites, and so of electrical grade, relatively near the surface; and larger quantities of structural grade. The topography was such as to provide adequate drainage. Sand and standing timber, useful, respectively, for finishing operations and for crating, were available in the neighborhood. The farm was within 15 miles of a railroad.

Mr. Slater also made extensive investigations with regard to the methods employed in other slate quarries, the kind and amount of equipment that would be required for his project, the costs of operations, selling prices, marketing conditions, and similar matters. He learned that known slate deposits of the highest quality were few in number and that there was a good demand for slate of that quality for switchboard use in

the plants of electric light and power companies, telephone companies, and all others using electric switchboards, and also to a lesser extent for tables, shelves, and sinks, especially in chemical laboratories, and for miscellaneous uses. He also learned that slate of lower but still merchantable quality found its principal use in the form of roofing slate, while the smaller fragments and odds and ends that would otherwise be waste found a fairly extensive, though not very profitable, market in the form of flakes to be used in coating asphalt shingles.

These investigations made it clear to Mr. Slater that his proposed quarry could be operated most profitably if, in connection with it, he built a small mill for working the slate into the forms in which it could be most advantageously marketed. He estimated that to provide hoisting and other equipment for the quarry, to build the mill to the full capacity which he contemplated including such equipment as saws, planers, and splitting machines, and to cover operating and miscellaneous expenses during the period required to open the quarry, develop the market for the product, and place the enterprise on a self-supporting basis would call for a cash investment of about $100,000. The full equipment required for the quarry, however, would not be needed until some depth had been attained; and he was fortunate in the fact that the merchantable slate, as indicated by the diamond drilling, came very near the surface in considerable quantity. He also proposed to start with a mill of somewhat smaller capacity than ultimately contemplated and to add additional mill equipment as the market was developed and the production of the quarry increased. With the initial expenditure thus reduced, he estimated that the cash capital required at the outset would not exceed $75,000.

On the basis of these estimates, Mr. Slater proposed to form a corporation, to be known as the Slater Quarry Corporation, to which he would transfer that portion of his farm containing the vein of slate, with enough adjoining land for all operating purposes, receiving in return from the corporation $100,000 par value of its capital stock. It would then be necessary to raise the $75,000 of additional capital required.

At this point in the development of the project, in the summer of 1936, Mr. Slater decided to visit an acquaintance, Mr. John Bannister, who was the president and principal stockholder of the bank in the neighboring county seat and also a man of considerable private means. He knew that Mr. Bannister had interests in several successful enterprises in the area and thought that he might be interested in investing in the new company.

At a brief preliminary discussion with Mr. Bannister, Mr. Slater described the deposit and, in general terms, his plans for a concern to exploit it. Mr. Bannister appeared somewhat interested in the project and expressed a desire to look over fairly carefully Mr. Slater's material regarding the nature and extent of the deposit and his estimates of the expense and income that might be expected for the suggested concern. Accordingly, Mr. Slater left some of the material with Mr. Bannister.

A week later Mr. Slater received a telephone call from Mr. Bannister. Mr. Bannister stated that he was inclined to agree as to the profit possibilities in good years but that it had been his experience that a new concern such as Mr. Slater proposed could expect to encounter difficulties in the manufacture and sale of its products, even if the raw material supply were excellent. Subject to the confirming report of an independent check on the deposit of slate, however, Mr. Bannister stated that he would be interested in discussing further the possibility of his investing substantially in the new corporation.

Mr. Slater was much encouraged by this reaction and was led to the hope that Mr. Bannister could be persuaded to furnish all of the $75,000 of cash capital initially required. In regard to arrangements, Mr. Slater seriously considered four major possibilities. As he thought about these possible arrangements, he endeavored to reach some conclusions as to the advantages and disadvantages of each arrangement from his own point of view and also as to how Mr. Bannister might be expected to react to each of the proposals if they were offered him.

The four arrangements Mr. Slater had in mind were as follows: The first was a $75,000 bank loan, for which the company would pay such rate of interest, not exceeding 5%, as Mr. Bannister might decide to charge. The second was for the bank or Mr. Bannister to buy at par an issue of $75,000 par value of 5% bonds, to mature in 20 years, with a sinking fund beginning to operate after the first five years through which two-thirds of the total issue would be retired before maturity in equal annual installments. The third was an issue of $75,000 par value of 6% cumulative preferred stock, to be purchased by Mr. Bannister at par. Such preferred stock would have equal voting power with the common, share for share; but since both common and preferred were to be in shares of $100 par value, it was evident that the common stock would have a majority of the votes. The fourth was the sale to Mr. Bannister at par of an additional $75,000 par value of common stock, thus giving the company a total stock capital of $175,000, all of one class, with no bank loans or funded debt.

Mr. Slater's estimates indicated that, with the initial equipment which he proposed and as soon as the operations of the company were well established, it should be able to earn from $17,500 to $20,000 a year before interest and income taxes.[1] Under any one of the four arrangements, Mr. Slater's plan contemplated that dividends on the common stock in the early years should be held to a low figure and that from $8,000 to $10,000 a year should be retained out of earnings and invested in equipment, until provision had thus been made for the $25,000 of additional equipment which, according to his estimates, would ultimately be needed. With this increased investment, Mr. Slater estimated that earnings could be expanded to an average level ranging from $20,000 to $25,000 a year. It was estimated that the supply of slate in the quarry would last at least 50 years.

[1] The federal corporate income tax rate in 1935 was 13¾% and in 1936 was 13% on net corporate incomes in the bracket $15,000–$40,000. In 1936 in addition there was an undistributed profits tax, which can be ignored by the student.

Longstreet Machine Company

On the morning of December 17, 1945, the board of directors of the Longstreet Machine Company was scheduled to meet for the purpose of considering two pending proposals for raising funds: one, a term loan; and the other, a public issue of common stock.

The Longstreet Machine Company, located in Springfield, Massachusetts, had manufactured textile twisting machinery since 1860. Management had remained in the Longstreet family. Currently, Richard Longstreet, grandson of the founder, was president; the latter's elder son was vice-president and sales manager, and another son was assistant to the plant manager. The company's stock was closely held, 65% being owned or controlled by the Longstreet family. The rest was held by officers and employees and a small number of individuals, estates, and charitable institutions.

The company produced 15 different types of machines. The great majority of the parts, however, were used in more than one type of machine. Normally, parts were manufactured for inventory in accordance with estimated needs. As sales were reported, assembly orders would be issued and the required parts withdrawn from inventory. Machines were not carried in stock and parts were not, as a rule, manufactured for specific orders. A substantial proportion of dollar sales, 35% in the five years preceding World War II, consisted of replacement parts.

Inventories were normally large and, since production of parts was based on forecasts of sales, would at times become excessive or unbalanced. In periods of declining business, many months would elapse before inventories could be reduced proportionately. During the five years ending in September, 1941, inventory averaged 40% of annual sales and 65% of current assets; finished parts varied from 46% to 68% of total inventory.

The greater part of the company's sales were made by its own sales

force. Sales offices were maintained in principal textile centers in this country and Great Britain; and in peacetime, traveling sales representatives served Europe, South America, Asia, and Australia. Fifty per cent of dollar sales prior to the war were made for foreign shipment, a far larger percentage than was characteristic of any of the company's competitors. Terms of sale were net/30 days to domestic customers and by letter of credit or 30-, 60-, or 90-day draft, with bill of lading attached on foreign shipments.

The company had been profitable but, typical of manufacturers of producers' goods, earnings were subject to considerable cyclical variation. Sales during the depression years of 1930 and 1931 declined 40% below the amount for the 1929 calendar year, resulting in substantial operating losses. Because of the specialized nature of the greater part of its inventory and because it was impossible to foresee how long the depression would last, inventories were not reduced proportionately to declining sales. In fact, inventories increased more than 5% during the fiscal year ending June 30, 1931. The losses of 1930 and 1931, combined with the failure to liquidate inventory and with sinking fund ($90,000 a year in the period 1927–1929 and $115,000 a year from 1930 to 1932) and interest requirements on a 7% bond issue, led to acute financial difficulties.

Late in 1930, Mr. Longstreet arranged to borrow $75,000 each from five banks, three located in Boston and the other two in Springfield and New York. In the second quarter of 1931, two of the Boston banks called their loans, and for a time it appeared that the others would follow suit. Mr. Longstreet, however, succeeded in persuading the remaining banks to renew their loans, and in the spring of 1932 the Pine Street National Bank, the company's New York bank, lent an additional $500,000. Following the 1933 upturn in the business cycle, the company's finances improved steadily. The bond issue was retired at its maturity in 1935 from the proceeds of additional bank borrowing. The company remained in debt to the banks thereafter, but the amount of its borrowings varied. In March, 1941, a $900,000, $2\frac{7}{8}$%, five-year term loan was arranged with Pine Street National Bank for the purpose of liquidating outstanding notes and supplying additional working capital necessitated by defense contracts.

During World War II military contracts accounted for approximately half the company's volume. The remainder of its output consisted of twisting machinery and replacement parts, with the latter pre-

dominating. No major changes in plant or equipment were required by military production; so the company experienced no plant reconversion problems when its last war contract terminated in August, 1945.

The company's management considered postwar sales prospects to be favorable. By December, 1945, its backlog of domestic orders had reached $5,000,000. Management also anticipated a large volume of foreign sales after world political and economic order was restored.

The management was concerned, however, about the longer-term outlook. Fostered by corporate income tax rates there had been an unusual amount of research and developmental work done in industry during the war. Two competitive developments were of especial concern to the management. One company which had not previously manufactured textile equipment had designed a machine which for many applications was apparently superior to the comparable Longstreet model. A second concern had secured a license from a foreign company permitting the manufacture of a greatly improved machine which would compete with another model. The two types of machinery, the sales of which were threatened by these new developments, normally constituted about a fourth of the company's dollar volume. The Longstreet Machine Company's management was currently devoting a large portion of its time and energy to developmental work, with especial attention to the two aforementioned models.

In addition to its engineering and marketing problems, the Longstreet Machine Company emerged from the war with a financial problem. Earnings had declined during wartime because of unprofitable military contracts and increased income tax rates, as shown in Exhibit 1 (p. 126). At the same time, larger than normal amounts were spent for replacing old machinery and equipment, as shown in Exhibit 3. Funds had been drained as a consequence, so that the company's cash balance on December 15, 1945, was $154,000, despite $300,000 raised in October on a 1½%, 180-day note. (See Exhibit 2.)

It had been apparent to the management throughout the autumn of 1945 that it would have to borrow to meet the $300,000 final payment, due March 31, 1946, on its five-year term loan. It was also apparent that additional funds would be needed to finance developmental research and working capital requirements until sufficient cash had accumulated from postwar earnings. At Mr. Longstreet's request, John Bragg, the company's treasurer, had compiled the following estimate of additional cash requirements for the coming year:

Expenditure	Amount Minimum	Amount Maximum
Developmental expense	$ 45,000	$ 135,000
Machinery, tools, fixtures, etc.	100,000	235,000
Plant construction	45,000	175,000
Working capital	85,000	350,000
Term loan installment	300,000	300,000
90-day note	300,000	300,000
	$875,000	$1,495,000

On November 19, 1945, Mr. Longstreet and Mr. Bragg discussed their financial needs with James Sheridan, an officer of the Pine Street National Bank. After studying the company's condition, Mr. Sheridan suggested a 3%, 10-year term loan in an amount up to $1,200,000. Participation in the loan would be offered to the company's other banks. The terms, as proposed by Mr. Sheridan, included the following covenants among others:

a) The loan would be repayable in 40 equal quarterly installments;

b) Net current assets of at least $1,500,000 would be maintained;

c) A current ratio of at least 2:1 would be maintained;

d) Annual and monthly balance sheets, profit and loss statements, and surplus reconciliations would be furnished;

e) Additional indebtedness with a maturity of more than 12 months would be limited to a maximum of $250,000;

f) Dividends (other than in stock) would not be paid nor would any of the company's stock be purchased if such payment or purchase would reduce surplus below the amount at the time of the signing of the loan agreement plus one-third of subsequent income otherwise available to the common stockholders; [1]

g) Accounts receivable would not be sold or property be encumbered except that foreign drafts receivable could be discounted up to an aggregate of $125,000;

h) Assets in excess of $50,000 would not be sold in any one year, except in the ordinary course of business, unless the amount in excess of $50,000 were applied to payment of the loan in inverse order of maturity;

i) Expenditures on real estate, machinery, or equipment would be limited to $275,000 plus retained earnings and depreciation accumulated subsequent to the signing of the loaning agreement. The figure of $275,000 might also be increased by the proceeds of subsequent sales of the company's common stock;

j) In the event of default in payment of principal or interest, or default in any covenant or warranty, or in certain other events, such as a general assignment for the benefit of creditors, or the filing of certain petitions or answers under

[1] The company had paid dividends on common stock, but very irregularly. Two dollars per share had been paid July 1, 1945, the first payment since 1942.

bankruptcy or reorganization laws, the lender would be able to declare the principal and interest of the entire loan immediately due and payable.

The day after Mr. Sheridan presented his proposal, Mr. Longstreet received a visit from Roger Burnside, a member of the New York investment banking firm of Sherman Brothers. Mr. Burnside explained that he was in Springfield in connection with his company's purchase for resale to the public of a block of common stock of another Springfield concern. He stated that his firm was on the lookout for additional business and expressed the hope that Mr. Longstreet would contact him if the Longstreet Machine Company should decide to raise funds through the sale of additional securities.

The brief discussion of a public issue of securities stirred Mr. Longstreet's imagination. He had had frequent occasion to reflect, since 1931, on the disadvantages of continual bank borrowing. Accordingly, a few days after the interview, a letter was sent to Mr. Burnside, and a meeting arranged for the following week.

At the outset of the conference, Mr. Longstreet expressed a preference, if securities were sold, for an issue of about $1,250,000 of 5% preferred stock. He explained that one reason for his preference was that preferred stock would be nonvoting and that he was desirous of keeping working control of the company in hands of the Longstreet family. On the other hand, he appreciated the fact that working control probably could be maintained with less than a majority of voting power. Mr. Burnside replied that a new issue could be marketed by the underwriters over a wide geographical area and in relatively small lots so as to minimize the possibility of groups, unfriendly to the Longstreet's, accumulating enough stock to challenge their management.

Mr. Burnside did not believe that the Longstreet Machine Company was financially strong or stable enough to make its preferred attractive to prospective investors unless it were to be convertible into common stock at the option of the holder. After some discussion Mr. Longstreet decided that he would prefer to issue common stock. In the event that preferred were issued and the preferred stockholders converted, as he thought that they would in view of prospective earnings for the next few years, the common stockholders' equity would be diluted about as much as if common stock had been issued in the first place. On the other hand, if anything happened to affect the company's prospects adversely and to discourage conversion, management would find itself faced with fixed dividend requirements at the very time it would want to conserve funds.

Accordingly, it was agreed to proceed on the basis of a common stock issue of $1,250,000. Mr. Burnside then left for New York to work out a preliminary proposal and to discuss the matter with his partners.

The proposal with which Mr. Burnside returned may be outlined as follows:

1. 105,000 shares of common stock would be issued at a tentative selling price to the public of $12 a share, after a 10 for 1 split of currently outstanding stock.
2. Underwriting fees would be 9% of the selling price.
3. Underwriter's legal expenses of approximately $6,000 would be borne by the company.
4. Five-year warrants for the purchase of 7,500 shares of new common stock at a price of $15 a share would be authorized and sold to Sherman Brothers for a total of $400. These warrants would, in effect, be options to buy Longstreet stock from the company at any time over the five-year period at $15 regardless of the current market value of the stock.

   Presumably the options would be exercised only at a time when the current market value was more than $15, and the difference between cost to Sherman Brothers and the market value could be regarded as additional, but contingent, compensation to the underwriter.
5. The final selling price would be set within 72 hours before the registration of the issue with the Securities and Exchange Commission would become effective and would be filed as an amendment to the registration statement. At the time the selling price was set, a purchase agreement would be signed by the company and Sherman Brothers. This agreement would provide that the underwriter could cancel his rights and obligations under the agreement at any time up to and including the "closing date" (i.e., date of delivery of the stock to Sherman Brothers and payment therefor to the Longstreet Machine Company) if in the judgment of Sherman Brothers political, financial, market, international, economic, or other general conditions changed so as to make the public offering of the stock impracticable or inadvisable. The "closing date" would be set at from three to four days after the effective date of the registration.
6. The stock would not be listed on an organized exchange, but the issue would be distributed widely. Wide distribution, it was believed, would result in frequent trading in the "over-the-counter" market.
7. Mr. Burnside would be elected to the board of directors at the next annual meeting.

The selling price proposed by Mr. Burnside was less than Mr. Longstreet had anticipated. The latter had counted on receiving a price about equal to the stock's book value. Mr. Burnside stated, however, that selling price was determined more by earnings than by book value. The $12 a share price was equivalent to slightly less than 10 times average earnings, on the stock currently outstanding, for the preceding 10 years. Mr.

Burnside had brought a schedule which showed that the common stock of other textile machinery companies was selling at about 11 times their earnings for the same period. In view of the fact that the company's stock was closely held and was unknown to the investing public, and since its past financial history was not so good as that of most of the other companies included in Mr. Burnside's schedule, he felt that 10 times earnings was a fair price. Moreover, the number of common shares outstanding would be almost doubled, and earnings would have to be increased proportionately to make the investment attractive.

Mr. Longstreet considered Mr. Burnside's analysis unfair because earnings in the preceding 10 years had been reduced by the recession of 1938 and by losses on war contracts. The real prewar earning power of the company, he maintained, was over $400,000 a year, after depreciation but before taxes. Moreover, Mr. Longstreet estimated that postwar earnings would be greater by at least an additional 25% because of manufacturing economies resulting from wartime improvements in plant and machinery and because of an anticipated abnormally large postwar demand. Thus, he felt that the company could look forward to earnings before taxes of at least $500,000.

Mr. Burnside replied that he agreed with Mr. Longstreet's analysis of the company's prospects but that the Securities Act of 1933 prevented his firm from using predictions and estimates as "bait" in selling securities to the public. The information that could be included in the prospectus was, in effect, limited to fact because the underwriter and the company's officers were liable for the statements contained therein. Moreover, Mr. Burnside stated that his firm liked to be associated with "successful issues." A "successful issue" was one which went up a point or two after its public offering. A "successful issue" was of benefit to the issuer as well as to the underwriter, he maintained, because it made the public more receptive to future issues of the same company.

Mr. Longstreet was unable to obtain any concessions from Mr. Burnside. During the following two weeks he sounded out several other underwriters, none of whom made offers which he considered more favorable than the one received from Sherman Brothers.

After discussing the matter with other company officers and with his lawyers, Mr. Longstreet called a meeting of the directors for December 17, 1945, for the purpose of considering means of raising funds. In his discussion with his lawyers, Mr. Longstreet had learned that getting out the proposed stock issue would take the following length of time:

five to six weeks to prepare the registration statement required under the Securities Act of 1933; about three weeks to receive a possible "deficiency letter" from the Securities and Exchange Commission outlining any revisions they would require; from one to two weeks to negotiate and file the amendments requested in the deficiency letter; and two to four days to "close" with the underwriter.

In further preparation for the board meeting Mr. Longstreet made some brief calculations which he planned to lay before the board. He first calculated the effect each plan, if adopted, would have on the earnings per common share outstanding. The effect was calculated first on the assumption of net earnings before taxes and interest of $500,000. In view of Mr. Burnside's more conservative view of future earnings he also figured out the effect of each of the proposed plans on earnings per share if earnings were about equal to the average of the last 10 years. Mr. Longstreet's calculations are shown in part in Chart 1 and Exhibit 4.

Exhibit 1

LONGSTREET MACHINE COMPANY

SUMMARY OF EARNINGS

(Dollar figures in thousands)

Fiscal Year Ending Sept. 30	*Net Sales*	*Income**	*Depreciation*	*Interest*	*Income Taxes*	*Net Income*
1936	$2,861	$515	$ 99	$12	$ 68	$336
1937	3,473	509	100	8	115	286
1938	2,920	329	100	4	53	172
1939	2,430	55	96	5	10	56[d]
1940	3,301	389	97	8	87	197
1941	3,341	433	110	14	81	228
1942	3,972	478	164	26	100	188
1943	2,963	190	147	26	18	1[d]
1944	2,954	398	147	21	86	144
1945	3,217	309	148	11	60	90
Average	.....	361	121	...	68	158

* Before depreciation, interest, and income taxes.
[d] Deficit

Exhibit 2

LONGSTREET MACHINE COMPANY

BALANCE SHEETS

(Dollar figures in thousands)

	*Sept. 30 1945**	*Dec. 15 1945*
ASSETS		
Current assets:		
Cash	$ 189	$ 154
Accounts receivable	300	443
Inventories:		
Raw material	236	...
Parts in process	501	...
Finished parts	749	...
Machines in process	268	...
Total inventory	$1,754	1,962†
Other current assets	8	3
Total current assets	$2,251	$2,562
Fixed assets:		
Land, building, machinery, etc.	$2,999	$3,059
Less allowance for depreciation	1,583	1,641
Total fixed assets	$1,416	$1,418
Other assets	49	56
Total assets	$3,715	$4,036
LIABILITIES AND CAPITAL		
Liabilities:		
Notes payable to banks:		
Due March 31, 1946	$ 325	$ 300
Due April 6, 1946		300
Accounts payable—trade	199	212
Customers' advances on contracts	32	40
Accrued liabilities	50	51
Provision for taxes	162	167
Total current liabilities	$ 768	$1,070
Capital:		
Common (no par, stated value $100)	$1,276	$1,276
Surplus	1,671	1,690
Total capital	$2,947	$2,966
Total liabilities and capital	$3,715	$4,036

* Audited.

† The company's cost accounting system did not provide a breakdown of inventory, which was obtainable only by means of a physical count.

Exhibit 3

LONGSTREET MACHINE COMPANY

EXPENDITURES FOR MACHINERY AND EQUIPMENT AND FOR DEVELOPMENT AND RESEARCH

(Dollar figures in thousands)

Fiscal Year Ending Sept. 30	*For Machinery and Equipment (Charged to Capital Accounts)*	*For Development and Research (Charged to Expense)*
1936	$ 89	$ 79
1937	97	110
1938	84	167
1939	105	182
1940	124	190
1941	443	219
1942	245	263
1943	117	196
1944	95	137
1945	170	155

Chart 1

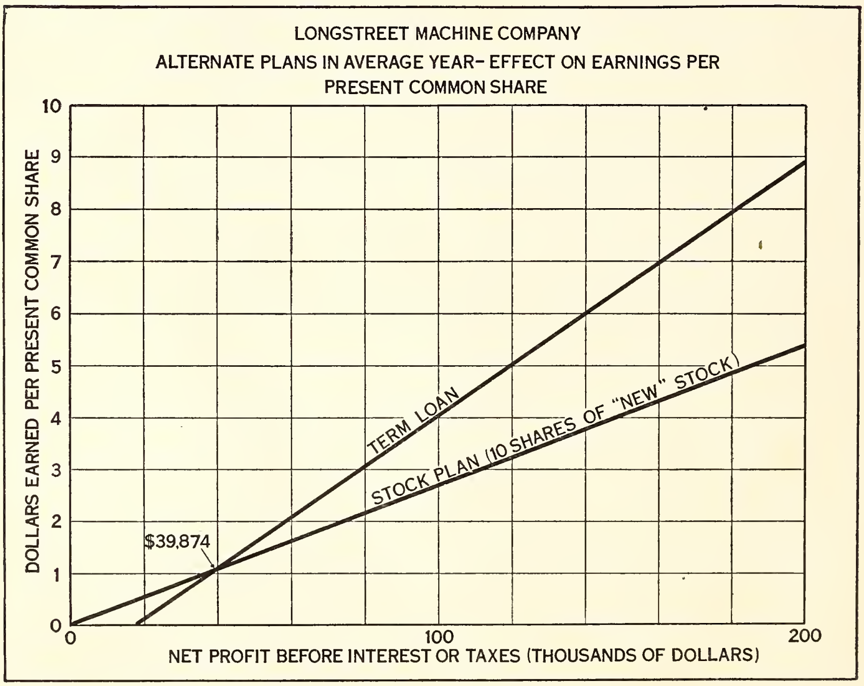

Exhibit 4

LONGSTREET MACHINE COMPANY

EFFECT OF ALTERNATE PLANS ON EARNINGS PER SHARE OF COMMON STOCK*

At Assumed Earnings Level of $500,000 before Interest and Taxes

	Term Loan	*Common Stock*
Assumed income before interest and taxes	$500,000	$500,000
Less: Interest at 3% on average loan outstanding	18,000	0
	$482,000	$500,000
Less: Taxes at 38%	183,160	190,000
Net income after taxes	$298,840	$310,000
Number of shares of stock	12,760	23,260*
Net income per share of present common stock	$ 23.40	$ 13.30

At Assumed Earnings Level of $240,000 before Interest and Taxes

	Term Loan	*Common Stock*
Income before interest and taxes	$240,000	$240,000
Less: Interest at 3% on average	18,000	0
Net income before taxes	$222,000	$240,000
Less: Taxes at 38%	84,360	91,200
Net income after taxes	$137,640	$148,800
Number of shares of stock	12,760	23,260*
Net income per share of common stock	$ 10.80	$ 6.40

* To provide comparability, this number is expressed in "old" shares.

Dixley Paper Company (A)

On February 5, 1946, the executive committee of the Dixley Paper Company was considering, as alternative methods of raising capital, the issuance of debentures and of preferred stock.

The Dixley Paper Company manufactured paper for industrial and commercial use. Sales were made direct, and through jobbers, to converters and industrial concerns. The company's papers were used in the manufacture of a wide variety of items. Management took great pride in the quality of its products, which enjoyed a high reputation in the trade. Over one-third of its customers had been doing business with the company for 25 years or more.

The paper industry was highly competitive. Over 450 concerns manufactured pulp, paper, and paper board in the United States in 1945, while substantial quantities of pulp and paper were imported from Canada and the Scandinavian countries. Total over-all capacity exceeded demand, as evidenced by the fact that the paper industry operated at about two-thirds of nominal capacity in the 20-year period ending with 1940. The industry was not dominated by any one company or group of companies. Notwithstanding competitive conditions, the Dixley Paper Company had a long record of profitability. (See Exhibit 1.) Common stock dividends had been declared every year for a half-century, and during the preceding decade annual payments had ranged from $2.00 to $3.00 a share. Since 1942 annual payments had been $2.50 per share.

The company's stock had been closely held prior to the death in 1939 of Amory Williams, a major shareholder. In the settlement of his estate, a large block of the Dixley Paper Company stock was sold to an investment banking firm which resold it to investors at a favorable price. The company was in no way connected with this transaction.

As was typical of the industry, sales declined more than 25% during

the depression of the early 1930's. Inventories and receivables were reduced more than proportionately, resulting in substantial accumulations of cash. This excess cash was invested in government securities and was also used to purchase such shares of company stock as became available at the depressed prices typical of the period. In 1936 management decided to use its "idle" funds to build a $7,000,000 mill in the South, at which it was planned to produce high strength sulphate Kraft paper to supplement the line of fine sulphite papers produced at the company's New England mills.

Construction of the southern mill was a lengthy process. Production of pulp was not commenced until late 1940 and paper was not produced until early 1941. Demand for paper products increased while the plant was under construction, necessitating additional investment in inventory and receivables, which was financed through bank loans. Late in 1940 a $3,000,000 3½% five-year term loan was arranged, the proceeds of which were used to liquidate debt incurred during the building of the plant and for working capital.

George Holmes, the company's treasurer, observed during the following year that companies with equivalent credit standing were obtaining bank loans on more favorable terms. Making a study of industrial borrowing, Mr. Holmes concluded that 2¾% was the current going rate for comparable loans. He sounded out several bankers and confirmed that they would be willing to lend the company sufficient money at 2¾% to refund the amount outstanding on the 3½% loan. Part of the success of the Dixley Paper Company was attributable to management's skillful bargaining with sellers of pulpwood and pulp. In its opinion, the hiring of money was essentially like the purchase of a commodity, and bankers were only human and could be bargained with just like other businessmen. Accordingly, a meeting was arranged with representatives of the bank at which it was pointed out that 3½% was too high an interest rate and that money was available at 2¾% for the purpose of refunding the loan. After some discussion, the bank consented to reduce its rate to the 2¾% figure.

Throughout World War II a critical shortage of pulpwood, pulp, and paper was experienced by the United States. This shortage was attributable to an unprecedented demand for pulp and paper products and to interruption of imports from Scandinavia. To meet this situation, the government established severe restrictions on the amount of inventory a concern could carry. In order to keep within War Production Board

allocations, the Dixley Paper Company was forced to sell substantial quantities of pulp. It also became necessary to reduce harvesting operations in company-owned woodlands because of a shortage of woods laborers. Reduction of inventories attributable to these influences provided sufficient cash to repay the \$3,000,000 term loan as it matured. This debt was completely paid early in 1945.

Lifting of government controls after the cessation of hostilities created a severe drain on cash. The ending of priorities and the ensuing scramble for pulpwood and pulp forced management to increase inventories to levels which would insure uninterrupted production under the new conditions. Because of increased sales attributable to the southern mill, which had nearly doubled the company's capacity, and the unprecedentedly great postwar demand for paper, management was faced with the necessity for carrying larger unit inventories than ever before in its history, while costs were 100% above prewar levels. In addition, substantial expenditures were required for repair and purchase of machinery, much of which was in poor condition because of wartime shortages of parts and replacements. This combination of factors created a need for more working capital than the company possessed. To meet the need, \$2,150,000 had been borrowed from banks on 90-day 1½% notes by November, 1945, and an additional \$550,000 in January, 1946.

Notwithstanding these borrowings, management foresaw need for additional cash. Expenditures for machinery and equipment during the next few years were expected to total close to \$2,400,000. About \$600,000 had been allocated for purchase of woodlands in the vicinity of the southern mill. Inventories, it was expected, might increase by as much as another two or three million, depending upon volume of sales, wage levels, availability of woods laborers, and the price and supply of purchased pulpwood and pulp.

Abundant bank credit was available, but management did not believe that it was sound financial policy to be continually in debt to banks. Management wished to borrow only during the winter and spring, when pulpwood inventories were at a peak, and to "clean up" its bank loans by late summer of each year. Harvesting and peeling of pulpwood started in the north in the early fall, at which time inventory was at its annual low and continued until the spring thaw, when a 12 months' supply of peeled logs was floated down the river to the company's pulp mill.

George Holmes, who kept in close touch with the securities market, had noted during the latter part of 1945 that many concerns were taking advantage of favorable market conditions to sell securities publicly. Mr. Holmes was confident that the company would be able to raise permanent capital on favorable terms under current market conditions because of its long record of profitability and financial strength. These views he introduced at a meeting of the executive committee late in January. The idea of a public issue was well received by the other officers. Opinion was divided as between preferred stock and debentures, with common stock being ruled out because it was known that the principal stockholders would oppose any substantial dilution of their equity. Accordingly, Mr. Holmes was asked to prepare a comparison of the terms that could be expected for a debenture issue and for preferred stock.

On February 5, 1946, Mr. Holmes presented alternative proposals for consideration. In preparing the plans he had given careful consideration to the terms on which other paper companies had issued securities in recent weeks and to the company's bargaining position.

Mr. Holmes conceded that prospective underwriters would vigorously object to the terms of underwriting compensation and selling prices he had outlined, but he was confident that his terms would finally be accepted. There was a good market for high-grade industrial debentures and preferred stock. The proposed issue would have no senior securities ahead of it, and interest or dividend requirements would be small relative to past earnings and to the dividends that had been paid, without fail, for 50 years. Moreover, the company's stock was quoted frequently on the over-the-counter market and had been known to New England investors since the sale of Amory Williams' block of shares in 1939. Distribution of the proposed issue would, Mr. Holmes stated, be an easy matter, with every likelihood that it would be oversubscribed. Mr. Holmes's plan was to negotiate with a number of underwriting firms simultaneously and to hold out until his terms were accepted by one or another.

Mr. Holmes's proposed terms for a $5,000,000 debenture issue may be outlined as follows:

1. Annual interest at the rate of 3% of face value.
2. Selling price to the public of about 103.
3. An underwriting fee of 1⅝% of selling price.
4. Sinking fund provisions calling for retirement of the issue over a 15-year

period with equal sinking fund payments each year. Debentures would be subject to call by lot for sinking fund redemption at the following prices:

1947	104	1955	101¼
1949	103	1958	100½
1952	102	1961	100

5. Provisions providing for redemption (other than for the sinking fund) of the issue in whole, or in part by lot, at the following prices:

1946	105	1955	101½
1949	103½	1958	100¾
1952	102¼	1961	100

6. Provisions prohibiting the company from creating, assuming, or guaranteeing mortgage indebtedness, except purchase money mortgages, unless the debentures were secured by such mortgage equally and ratably with all other indebtedness so secured.
7. Provisions prohibiting the creation, assumption, or guaranteeing of funded debt unless net tangible assets were at least 250% of the sum of funded debt to be outstanding and net income for the two most recent fiscal years shall have averaged 250% of the sum of annual interest charges on funded debt to be outstanding.
8. Limitation of the right to pay cash dividends if such payments would reduce surplus below the amount at the time of issue or reduce current assets below 200% of current liabilities, or if interest or sinking fund payments on the debentures were in arrears.
9. In the event of default (after 30 days' grace period on interest and 60 days' grace period on sinking fund payments), the trustee, or holders of not less than 25% of the debentures outstanding, could declare the principal of all debentures to be due and payable immediately.
10. Modification and alteration of the indenture could be made with the consent of the company and holders of two-thirds of the debentures, subject to the following exceptions:
    a) No changes could be made in terms of payment of principal at maturity or of interest or premium.
    b) No limitation could be made of the right of any debenture holder to institute suit for the enforcement of any such payment after its due date.
    c) No reduction could be made in the proportion of debentures required to modify or alter the indenture.

Mr. Holmes' proposed terms for a $5,000,000 preferred stock issue were as follows (see page 138):

Exhibit 1

DIXLEY PAPER COMPANY

SUMMARY OF EARNINGS

(Dollar figures in thousands)

Year	*Net Sales*	*Depreciation, Amortization, and Depletion*	*Profit after Depreciation before Interest and Income Taxes*	*Interest on Bank Loans*	*Provision for Federal and State Taxes on Income*	*Net Profit*	*Dividends Declared**
1936	$ 7,742	$ 387	$ 736	. . .	$ 95	$ 641	$583
1937	8,694	447	1,096	. . .	158	938	700
1938	7,231	410	146	. . .	11	135	466
1939	8,930	421	925	. . .	150	775	466
1940	9,856	594	933	$ 79	195	659	466
1941	18,010	1,016	3,258	132	1,560	1,566	700
1942	18,637	1,035	3,602	78	2,407	1,117	583
1943	20,683	1,062	2,187	49	1,269	869	583
1944	19,110	1,126	1,557	19	823	715	583
1945	21,329	1,235	1,741	22	955	764	583

* Actual outlay for dividends was reduced by amount of dividends on common stock held as "treasury stock."

Exhibit 2

DIXLEY PAPER COMPANY

BALANCE SHEETS

(Dollar figures in thousands)

ASSETS	*Dec. 31 1943*	*Dec. 31 1944*	*Dec. 31 1945*
Current assets:			
Cash	$ 1,332	$ 507	$ 607
Government securities (at cost or market)	58	43	84
Accounts receivable, net	1,551	1,706	1,840
Inventories	3,293	4,626	7,036
Deposits with mutual insurance companies	140	128	202
Total current assets	$ 6,374	$ 7,010	$ 9,769
Fixed assets:			
Real estate, machinery, and equipment	$22,405	$22,683	$22,956
Less: Reserve for depreciation and amortization	10,105	10,789	11,662
Balance	$12,300	$11,894	$11,294
Woodlands and stumpage	$13,157	$13,147	$13,146
Less: Reserve for depletion	7,150	7,270	7,485
Balance	$ 6,007	$ 5,877	$ 5,661
Total fixed assets	$18,307	$17,771	$16,955
Deferred charges and other assets	249	442	404
Total assets	$24,930	$25,223	$27,128

LIABILITIES

Current liabilities:			
Notes payable to banks	$ 1,300	$ 900	$ 2,150
Accounts payable and accrued expenses	500	1,117	1,686
Federal income taxes:			
Provisions	1,315	833	972
Less: U.S. Treasury notes	1,297	833	972
Balance	$ 18	.....	.....
Total current liabilities	$ 1,818	$ 2,017	$ 3,836
Reserve for industrial accidents			48
Reserve for wartime and postwar contingencies	595	595	595
Capital stock:			
233,333 shares no par common	17,500	17,500	17,500
Surplus	5,887	5,981	6,018
Balance	$23,387	$23,481	$23,518
Less: Treasury stock	870*	870*	870*
Total liabilities and capital	$24,930	$25,223	$27,128

* 12,341 shares.

1. Cumulative annual dividends of $4.00 a share on shares of par value of 100.
2. Selling price to the public of about 105.
3. An underwriting fee of $2.00 a share.
4. Provisions providing for redemption of the issue in whole, or in part by lot, at the following prices:

1946	109	1955	107½
1951	108½	1957	107
1953	108	1959	106½
		1961 and thereafter	106

5. Provisions providing for a retirement fund, starting in 1950, whereby 2½% of the original issue would be redeemed annually. Shares would be subject to call by lot for retirement fund redemption at the following prices:

1950	107	1955	105½
1953	106½	1956 and thereafter	105
1954	106		

   As an alternative, the company would be allowed to surrender for credit to the retirement fund, at the current redemption price, shares purchased and then held as treasury stock.
6. Upon the liquidation or dissolution of the company, holders of the preferred stock would be entitled to receive $100 a share plus accrued and unpaid dividends if the liquidation were involuntary or the redemption price then in effect (applicable to redemption other than through the retirement fund) if the liquidation or dissolution were voluntary, before any payment or distribution would be made on the common stock or on any other class of stock junior to the preferred stock.
7. The company would not, without an affirmative vote of at least two-thirds of the preferred stock, do any of the following:
   a) Authorize stock ranking prior to or on a parity with the proposed issue.
   b) Incur funded debt unless: net tangible assets were not less than 250% of the sum of funded debt to be outstanding plus the involuntary liquidating value of the preferred stock; net income for three out of the four most recent fiscal years shall have averaged 250% of the sum of annual interest charges on funded debt to be outstanding plus annual dividend requirements on preferred stock.
   c) Pay dividends on stock junior to the preferred if such payments would reduce surplus below the amount at the time of the issue or if preferred stock dividend or retirement fund payments were in arrears.
8. In the event that preferred stock dividends or retirement fund payments were in arrears in an aggregate amount equal to one year's requirements, the holders of the preferred stock would have the right, voting separately as a class, to elect one-third of the total number of directors.

Vickery Department Store

Following the end of the war in 1945, the management of the Vickery Department Store developed plans for modernization of its two existing store buildings, for expanded warehouse facilities, and for a new store building in a growing part of its city. These plans would require large amounts of funds over a period of years. But by the middle of 1946, it became clear that the rapid increase of sales would require about $2,000,000 for working capital before the program of expansion could be perfected. Alternate sources for this immediate requirement appeared to be a bank term loan or a "sale and lease-back" of company property.

Exhibit 1 shows the most recent balance sheet; Exhibit 2 shows a summary of operating results for the past 10 years.

In June, 1946, the company had arranged with a large New York bank a term loan commitment whereby the company could borrow $2,200,000 at 2¼% per annum on or before July 15, 1947. If the loan were "taken up" in full, principal was to be repaid in annual amounts of $220,000 from 1948 to 1955, inclusive, with a final payment of $440,000 in 1956. A stand-by commission of ¼ of 1% of the possible loan was to be charged on the full amount of this commitment until it was borrowed.

The loan agreement required the company to maintain at all times a net working capital of at least $3,500,000 and to obtain the bank's consent in order to:

1. Mortgage or pledge any property for loans in excess of $3,000,000; an exception to this requirement was "purchase money obligations" not exceeding 66⅔% of cost of property acquired after December 31, 1945;
2. Create any funded debt unless afterwards the tangible assets less current liabilities were not less than 166⅔% of the sum of the funded debt and the par value of the outstanding preferred stock;
3. Pay any dividends, except in stock, after January 31, 1945, except to extent of net earnings subsequent to January 31, 1945, plus $300,000.

"Sale and lease-back" arrangements were growing in frequency; and Mr. Kingdon, treasurer of Vickery, learned the general outlines of such financing through his acquaintance with an officer of another company which had recently entered such an agreement. This particular company had received $6,750,000 for the sale of its real estate (land and buildings) to an insurance company. Simultaneously, the company had agreed to lease the property it had sold for a period of 22 years under the following schedule of rental payments:

For each lease year (February 1 to January 31) of the first five years	$515,000
For each of the next five lease years	460,000
For each of the next five lease years	415,000
For each of the next five lease years	365,000
For the next lease year	300,000
For the final lease year, ending January 31, 1968	295,000
	$9,370,000

This schedule permitted the lessor to earn $3\frac{1}{2}\%$ on the investment, while writing it off over the 22 years.

The principal provisions of the lease to which Mr. Kingdon's acquaintance was a party were as follows:

1. Lessee shall pay as additional rent all real estate taxes, assessments, water rates, etc.
2. Lessee shall keep all buildings insured to at least 80% of their full insurable value and will indemnify the lessor from any liability or expenses for injury to person or property of any nature.
3. Lessee shall keep all buildings in good repair at the sole cost of the lessee, reasonable wear and tear excepted.
4. Trade fixtures, furniture, and equipment now installed shall not become part of premises, but all alterations and building equipment shall become part of premises and shall remain at the termination of the lease.
5. In the event that the property is condemned the lease shall end and the award shall be apportioned between the lessor and lessee upon a predetermined formula.
6. The lessee shall have the right at any time to make such alterations, changes, and new constructions as the lessee shall deem desirable to suit the lessee's convenience, provided that, if the estimated cost of such alteration is in excess of $100,000, the buildings after the completion of such project shall be of a value that is not less than that prior to the alterations.
7. If at any time the lessee shall desire to demolish 50% or more of the floor space for the purpose of erecting a new building, the lessee shall not commence demolition until the plans of the new building have been approved by the lessor; and the lessor covenants that it will not unreasonably withhold its approval of such plans.
8. The lessee shall have the right, at its option, to extend the lease for three

separate renewal terms of 22 years each. The conditions and agreements of the original term shall pertain, except that the rent for each renewal term shall be at the rate of $75,000 per annum. The lessee shall not have the right to extend the lease for any term beyond January 31, 2034.

Working on the assumption that the entire properties of the warehouse and the Main Avenue store could be sold at book value, Mr. Kingdon determined that a lease similar to the one which he had reviewed would call for rental payments approximately equal to the following schedule:

For each lease year for the first five years, annual rent of	$158,620
For each lease year for the next five years, annual rent of	141,680
For each lease year for the next five years, annual rent of	127,820
For each lease year for the next five years, annual rent of	112,420
For the next lease year, annual rent of	92,400
For the last lease year, annual rent of	90,860

In studying the provisions of such a lease Mr. Kingdon noted that all of the expenses currently incurred by the company in carrying the several properties would be included either in the rental payments to the lessor or in the miscellaneous charges which the lessee would agree to carry. In his own thinking, however, Mr. Kingdon was accustomed to regard the alternative earning power of money invested in property as a hidden cost of carrying the investment in the property. In other words, if the funds were not "tied up" in the particular property, he felt that they could have been invested in good stocks or bonds and an income of about 4% obtained on the investment. By entering into a sale and lease-back arrangement, the company would, in effect, free the funds currently invested in property for other uses. However, included in the rental fees would be the interest, presumably 3½%, the lessor expected to earn on its investment in the properties. Exhibit 3 summarizes Mr. Kingdon's calculations of the hidden cost of the current investment by Vickery in the several properties. $797,125

In studying the information in Exhibit 3, Mr. Kingdon realized that the value of land ($571,905) would be written off over the 22-year period through the rental charges. Since the cost of the land could not ordinarily be recovered through depreciation charges, inclusion of land amortization charges in the rental payments would effect a tax savings under current rates of about $10,000 yearly.

Mr. Kingdon wondered about the possibility of repurchasing the property at the end of any proposed lease. Although the lease he had examined did not include any such provision, he was aware that repurchase options were permissible.

Exhibit 1

VICKERY DEPARTMENT STORE

BALANCE SHEET AS OF JANUARY 31, 1946

(Dollar figures in thousands)

CURRENT ASSETS		
Cash and U.S. obligations		$ 2,264
Receivables (less reserve $150)		1,649
Merchandise		3,162
Total current assets		$ 7,075
Land		797
Buildings, improvements, furniture and fixtures	$4,628	
Less: Reserve for depreciation	2,634	1,994
Nonoperating properties		290
Miscellaneous assets		670
Total assets		$10,826
CURRENT LIABILITIES		
Accounts payable		$ 1,325
Provision for federal and state income taxes (less U.S. tax notes $600,000)		1,023
Accrued miscellaneous liabilities		602
Total current liabilities		$ 2,950
Reserves for self-insurance		30
4¼% cumulative preferred, $100 par—authorized and issued, 26,400 shares		2,640
Common, no par, authorized 47,500 shares, outstanding 42,996 shares	$ 260	
Less: Treasury stock 4,504 shares	157	103
Earned surplus		5,103
Total liabilities		$10,826

Exhibit 2

VICKERY DEPARTMENT STORE

SUMMARY OF OPERATING RESULTS

(Dollar figures in thousands)

Years Ended Jan. 31	*Net Sales*	*Profits before Income Taxes*	*Income Taxes*	*Net Profits*	*Dividend Paid*
1937	$10,392	$ 503	$ 155	$348	$162
1938	11,112	446	133	313	162
1939	10,165	297	73	224	130
1940	10,405	391	103	288	219
1941	10,859	533	157	376	259
1942	13,458	905	485	420	268
1943	15,205	1,315	866	449	259
1944	17,453	1,670	1,182	488	259
1945	20,139	2,252	1,686	566	258
1946	23,236	2,542	1,837	705	264

Exhibit 3

VICKERY DEPARTMENT STORE

Depreciated Value of Property (Excluding Automobiles) as of Jan. 31, 1946

		Earning Power at 4% of Funds Now Invested in Property
Main Avenue:		
Land	$ 552,740	$ 22,110
Buildings	806,181	32,248
Equipment	423,946	16,957
Total branch property	$1,782,867	$ 71,315
Seventh Street:		
Land	$ 225,220	$ 9,009
Buildings	341,905	13,676
Equipment	141,994	5,679
Total branch property	$ 709,119	$ 28,364
Warehouse:		
Land	$ 19,165	$ 766
Buildings	252,437	10,097
Equipment	23,361	935
Total warehouse property	$ 294,963	$ 11,798
Total all property	$2,786,949	$111,477

Consolidated Motive Company

In July, 1946, the directors of the Consolidated Motive Company decided to refund its \$7.00 cumulative preferred stock. The \$7.00 preferred stock, of which there were 100,000 shares outstanding, was callable at \$115 a share, making a total of \$11,500,000 required for calling the entire issue.

The directors had considered various alternative methods of financing the proposed refunding and eliminated all but the following:

1. The issue of \$11,500,000 par value 4% sinking fund 15-year debentures. It was thought that such an issue of debentures could be sold at a price to the public of 104. Underwriter's fees and other expenses of issue were expected to total about 4% of par so that the company would net the face value of the proposed issue. Proposed sinking fund provisions called for retirement of $3\frac{1}{3}$% of the par value of the issue each year. Bonds could be called by lot at the price of 105 for this purpose. Thus, bonds with face value of \$383,334 would be retired each year, leaving a total of \$5,750,000 outstanding at maturity date.
2. The issue of 115,000 shares of \$5.00 cumulative preferred stock. It was thought that this issue could be sold to the public at \$105 a share. Underwriter's fees and other expenses of issue were expected to total \$5.00 a share. It was proposed that the new issue provide that in the event of nonpayment of a total of one year's dividends the preferred stockholders would be entitled to elect 2 of the company's 15 directors. A similar clause was contained in the provisions of the currently outstanding issue of \$7.00 preferred. The new issue would be callable at \$110 a share. Neither the current nor the proposed issue of preferred contained any sinking fund provisions.
3. The sale of additional common stock to the public. (The current common stockholders had no pre-emptive rights to purchase additional common stock.)

The price range of the common stock on the New York Stock Exchange in recent months had been as follows:

	High	*Low*
January	44½	38¼
February	43⅞	35⅛
March	37⅜	34⅝
April	38⅜	35
May	40¾	35½
June	40½	36¼

Company officials had discussed the problem of financing with a prominent New York investment banking firm. The investment bankers felt that each of the above means of raising funds was currently feasible. Barring a change in market conditions, they expressed a willingness to act as principal underwriter for either bonds, preferred stock, or common stock on the basis outlined. It was the bankers' opinion that a new issue of common stock could be sold to the public at about 36. After deduction of the bankers' charges the company would receive about $34.50 per share. However, the company could expect additional expenses connected with the issue of common stock of roughly $60,000. Hence, to net $11,500,000 an issue of approximately 335,000 shares of new common stock would be required.

There were currently 875,000 shares of common stock outstanding. These shares were widely distributed; no single group could be said to dominate the company, and the directors did not consider it likely that anyone would seek to gain a controlling interest.

The Consolidated Motive Company manufactured steam and Diesel-electric locomotives. The great majority of the company's sales were made on a contract basis. Except for a relatively small stock of replacement parts, the company did not produce for inventory. As a means of compensating for unfavorable trends in the railroad industry, the company in 1931 undertook the manufacture of heavy distillation equipment for the chemical and petroleum industry.

Despite some success with the distillation equipment line, locomotives and locomotive parts still comprised the bulk of the company's peacetime sales; and the company's sales continued to be subject to wide cyclical variation. The Consolidated Motive Company was hard hit during the depression of the 1930's, as may be seen from a study of Exhibit 1.

Sales and earnings increased substantially during the war and the prewar rearmament period. In addition to the manufacture of locomotives for the military, the company undertook the manufacture of tanks

and other war products on a large scale. The company's earnings during this period are given in Exhibit 1.

In 1943 a recapitalization plan was adopted which eliminated the accumulated dividend arrearages on the preferred stock. The net effect of this plan was to give the preferred stockholders 1.715 shares of common stock for each share of preferred in lieu of the $42 per share of accumulated dividends. The amount of common stock outstanding was thereby increased from 375,000 shares to a new total of 675,000. The number of preferred shares and the $7.00 cumulative dividend rate remained unchanged.

In October, 1945, the company sold 200,000 shares of common stock to the public at a price of $36 a share. Underwriters' fees were $1.50 a share and other expenses connected with the issue totaled $60,000. The proceeds of this issue, plus $1,780,000 of excess cash, were used to call 75,000 shares of $7.00 preferred stock, leaving a total of 100,000 shares outstanding.

The company's current cash position, as shown by Exhibit 2, was strong. Anticipated increases in working and fixed capital, however, were expected to absorb most, if not all, of the funds currently invested in government securities.

Company officials regarded the immediate outlook for earnings in July, 1946, as highly favorable. Profits before taxes for the first half of 1946 amounted to $2,750,000 ($1,700,000 after taxes of approximately 38%). Two quarterly dividends of $0.35 per share had been declared on the common stock. The backlog of unfilled orders was equal to about 12 months' normal production. In addition to strong domestic demand for locomotives and distillation equipment attributable to favorable conditions in the railroad and chemical industries, foreign demand for the company's products was unusually heavy.

Exhibit 1

CONSOLIDATED MOTIVE COMPANY

FINANCIAL DATA

(Dollar figures in thousands)

Year	Depreciation	Net Profit or Deficit before Taxes	Net Profit or Deficit after Taxes	Preferred Dividends Paid	Common Dividends Paid	Preferred Stock Prices High	Preferred Stock Prices Low	Common Stock Prices High	Common Stock Prices Low
1927	$ 847	$ 4,420	$3,196	$1,225	$3,000	127	119½	116	99¼
1928	753	2,143	2,086	1,225	3,000	134	103¼	115	87
1929	715	3,683	3,426	1,225	3,000	120	111¼	136	90
1930	609	2,058	1,889	1,225	1,690	118½	68¼	105	18¼
1931	821	1,965^{d}	1,965^{d}	1,225	375	84¾	29½	30¾	5
1932	723	2,295^{d}	2,295^{d}	919	Nil	49	17⅝	15¼	3⅝
1933	281	918^{d}	918^{d}	Nil	Nil	63	17¾	39⅛	5⅞
1934	293	883^{d}	1,026^{d}	Nil	Nil	74⅝	35½	38¾	14½
1935	322	685^{d}	710^{d}	Nil	Nil	75¼	32	27¾	9
1936	268	660	578	525	Nil	122½	66	48⅜	23⅛
1937	338	3,358	3,407	1,225	Nil	125	53	58⅞	14½
1938	346	624^{d}	651^{d}	Nil	Nil	79	44	30⅝	12⅜
1939	448	441^{d}	475^{d}	Nil	Nil	79½	41	30⅜	13
1940	717	1,897	1,426	875	Nil	92	38	22¾	10
1941	1,167	5,359	3,315	1,225	Nil	95¼	77¼	17⅛	7¼
1942	1,912*	15,575	3,676	1,225	Nil	91	65	10¼	6¼
1943	1,963*	20,214	4,664	1,225	338	84¼	68	17½	7¾
1944	1,979*	16,530	4,483	1,225	878	111¼	80½	28⅛	14⅞
1945	2,067*	12,589	3,576	700†	919	123	108	41⅜	26

* Depreciation during the war years was at a greater rate than normal because of federal laws permitting plant and equipment purchased under wartime certificates of necessity to be depreciated over a five-year period. After V-J Day the government permitted undepreciated balances on such plant and equipment to be charged to income as of September 30, 1945. On the basis of the income report for the five months ending May 31, 1946, an annual peacetime depreciation charge of about $1,450,000 was indicated.

† Does not include dividends on preferred stock called during the year.

^{d} Deficit.

Exhibit 2

CONSOLIDATED MOTIVE COMPANY

BALANCE SHEET, MAY 31, 1946

(Dollar figures in thousands)

ASSETS

Cash		$ 6,582
U.S. government securities, at cost		5,754
Accounts receivable, net		6,359
Termination claims (U.S. government)		2,376
Inventories:		
Raw materials	$ 4,589	
Work in process	10,897	
Finished products	1,136	16,622
Total current assets		$37,693
Investments		1,679
Fixed assets, net		13,183
Deferred charges		317
Total assets		$52,872

LIABILITIES

Accounts payable	$ 4,396
Dividends payable	482
Accrued liabilities	2,776
Advances from customers	5,164
Reserve for income and excess profits taxes	7,690
Total current liabilities	$20,507
Liability for purchase of government facilities	395
Reserves:	
Accident indemnity	1,058
Contingency	3,826
Capital stock:	
Preferred, $7.00	10,000
Common, $1.00 par	875
Surplus:	
Capital	6,500
Earned	9,711
Total liabilities	$52,872

Cellulose Corporation

Immediately after World War II, Cellulose Corporation embarked upon a long-term expansion program that was expected to require many millions of dollars. This expansion was financed over a period of time through a combination of internal sources, the use of part of the proceeds of a convertible preferred issue sold in April, 1946, and a $36,000,000 debenture issue sold in October, 1946. By the fall of 1947 further production facilities were required and it was deemed advisable to raise $30,000,000 to finance part of this enlarged expansion program. At first, plans were made to sell $30,000,000 of 4% preferred stock. It became apparent, however, that this stock could only be marketed with dividend or sinking fund rates which the company's directors thought unreasonable. Consequently, a "stand-by" bank credit of $30,000,000 was arranged and drawn down to the extent of $12,000,000 to take care of current payments in the construction program. In January, 1948, the finance committee of the board of directors, headed by Mr. Bryan D. Knowles, was considering whether the financing should be put on a permanent basis.

Before the Second World War the Cellulose Corporation was a large manufacturing concern specializing in cellulose acetate products for use in the textile and plastics industry. Its issues of preferred and common stock enjoyed a high investment standing. As the consequence of extensive developments in the field of organic chemistry during the war, the company spent $34,800,000 for new manufacturing facilities in the period from 1941 to 1945, inclusive. In 1945 the company announced plans for a $55,000,000 expansion program to be spread over a four-year period. One year later, revised plans were made public to spend $60,000,000 on new facilities, half of which were scheduled for 1946. These funds were to be obtained partly from new financing.

Annual net profits after taxes in the years 1937–1945 were in the

range of \$6,000,000 to \$8,000,000 with the exception of 1938, when they dropped to \$3,780,000. With the removal of excess profits taxes, profits after taxes rose to \$12,600,000 for the year 1946. Dividends had been paid on the common shares each year since 1924. Exhibit 1 (p. 159) and Charts 1 and 2 (p. 160) portray the growth of the company.

The principal executives of the company had long considered that this type of growing industrial company should be financed by means of stock rather than by debt. As of December 31, 1945, the company's capitalization included 252,000 shares, $4\frac{1}{2}\%$ cumulative preferred stock outstanding, with a par value of \$25,200,000. This stock had been issued at a time when $4\frac{1}{2}\%$ was considered a very good rate. There were 4,564,325 common shares outstanding, with a total par value of \$22,821,624.

The directors decided early in 1946 that the expansion should be financed by preferred stock issues and in preparation for this financing called a special meeting of the shareholders, who authorized the directors to issue up to 625,000 shares of preferred stock as they might decide. This authorization was unusual in scope. In addition to allowing the directors to decide upon the details of any issue, e.g., amount, rate, type, and series, the stockholders also voted to the directors the right to reissue at any time any of the preferred stock that might have been redeemed, or converted into common, rather than stipulating that such shares should be canceled. This "open-end" provision was designed to set up a "revolving" preferred stock authorization and to provide the company with a flexible financing vehicle during future expansions. This was an important consideration inasmuch as the institutions which were expected to buy large blocks of the company's preferred issues usually refrained from voting their shares. This often made it difficult to secure the necessary quorums and majorities to authorize new issues. Furthermore, it was felt that it might not be easy to persuade a preferred holder that it was to his advantage to place another issue *pari passu* to his stock.

Early in April, 1946, under this authorization, the company sold 380,360 shares, \$100 par, $3\frac{1}{4}\%$ preferred stock, convertible into common stock on the basis of two shares of common for one share of preferred. Under the company's charter no obligation existed to offer common shareholders a pre-emptive right to subscribe to this issue. Nevertheless, the directors decided to grant to the common stockholders the right to subscribe pro rata to the issue of new preferred

stock at a price of $101.50 and arranged a stand-by underwriting agreement with the investment house of Ludlow, Milner & Co. The management felt that issuing rights always pleased the stockholders and therefore took the opportunity to do so. The market was considered relatively stable at the time, so no great price declines were expected while the rights were outstanding.

A small part of the shares, $1\frac{1}{2}\%$ of the total, was not taken up by the exercise of warrants and was sold to the public at $122 per share by Ludlow, Milner & Co., who paid to the company 80% of the proceeds in excess of $101.50. Altogether the issue provided $38,318,400 to the company. These funds were used to the extent of $27,150,000 to retire all the previously outstanding preferred stock while the remainder, $11,168,400, was earmarked for the expansion program.

When this new convertible preferred was being worked out, market conditions led the directors to plan to make the conversion privilege on the basis of $41 per common share, but as the market advanced from about $38 during the period of making plans and registering the issue the conversion basis was changed to $45, and finally to $50 per share or two common shares to one preferred share. The management felt that these shares would be converted in the future because the common had often sold on the basis of 20 times earnings. Since the budgeted earnings were $4.00 per share of common stock, the management believed that the price of the common might well reach $80 per share. Ludlow, Milner & Co. advised the directors that to make a convertible feature attractive the conversion rate could not be more than 10% above the current market for the common. If the conversion feature was to become attractive to buyers who wanted quick profits it was deemed advisable to place the conversion price at not more than 5% above the market price of the common.

If the common shares could have been sold directly at $50 per share, the directors would probably have used this method to raise the required funds. However, Mr. Knowles believed that a proposal to issue about 250,000 common shares would depress the market to the extent that it would not absorb the issue over $40. Therefore, a convertible preferred, convertible at $50 per share, was chosen in the hope that it would be converted into common in a short time. The directors announced their intention of calling the preferred issue as circumstances warranted.

From January 1 to March 15, 1946, the price of the common rose

from $\$38\frac{1}{2}$ to \$50 and the weekly volume of trading increased from 4,500 shares to more than 12,000 shares. On April 1, the market was \$50, and by Monday, April 8, the day the new preferred was issued, it had increased to $\$54\frac{3}{8}$. By Wednesday of the same week it had fallen to $\$49\frac{5}{8}$. The explanation given in market circles for this erratic movement was that the upward swing had its basis in the optimistic business prospects of the company, while the decrease that followed was due in part to the shares going ex-rights and also to the pressure of selling by common shareholders to secure funds to buy the preferred. In the succeeding week under the impetus of a strong bull market the price moved up to $\$56\frac{1}{2}$ and once to a peak of $\$59\frac{3}{8}$ in the latter part of May, 1946.

By June the new convertible preferred stock reached a peak price of $\$135\frac{1}{2}$ per share, its high for the year, 1946. The course of the prices of both classes of stock in 1947 is shown in Chart 3 (p. 163).

During the summer and early fall of 1946, the directors took up the question of further financing for capital expansion, and an issue of debenture bonds was favorably considered for the first time in company history. The majority of the board seemed to think that the company had an adequate base of junior securities outstanding and could justifiably issue a senior security. Mr. Knowles, who was of this opinion, reasoned that if \$36,000,000 of debentures were sold, there would be only \$74,000,000 in preferred stocks and bonds as compared with a base of \$264,000,000 in common stock equity, measured by the market price. The idea of debt was a deviation from the directors' basic policy of "leaving the top open," but it was considered because it was felt that more time should be given for the market thoroughly to absorb the convertible preferred issue before additional preferred was issued. In this connection, the directors also had in mind their policy of calling the preferred stock for redemption (at a price of \$104.50 plus accrued dividends) if the market price of the common shares was sufficiently above the "conversion price" of \$52.25 (\$104.50 ÷ 2).

On October 31, 1946, the company sold to five insurance companies, at par, \$36,000,000 of 2.65% debentures due in 1971. The bond indenture required that annual sinking fund payments of \$1,200,000 be commenced in 1957 in order to retire one-half the issue prior to maturity. There was no stipulation, however, limiting further issues of any type of security.

After placing the bond issue, the directors took under consideration

actions which would force the conversion of the preferred shares into common. The common dividend was increased to a rate of $2.00 per share as of January 30, 1947. Conversion was then favorable to preferred shareholders from the dividend aspect. Experience with the history of convertible issues showed, however, that the majority of the preferred holders would probably not convert unless they were forced to do so by having their shares called for redemption. However, the time required to go through the procedure of call complicated the problem. Fifteen days' notice was required to be given to the New York Stock Exchange of the company's intention to call the security, plus 30 days' notice to the particular shareholders whose shares were called. While the directors desired to call all the preferred shares at the earliest time, they were reluctant to commit the company to the extent of $39,941,350 over such a 45-day period. If the market price of the common should decline below $52.25, most of the preferred holders would take the cash payment of $104.50 per preferred share. Therefore, it was planned to force the conversion of the issue by stages so as to minimize this risk.

Chart 3 presents the 1947 course of the stock market prices of the common stock. In March, 1947, 11 months after the issue was sold, 18,000 shares had been converted voluntarily. At this time the company called 76,800 of the preferred shares. With the market of the common for the week ending February 21 at $57⅜–$59 and the weekly volume of trading at 6,000 shares the management did not feel that more could be called without risking the possibility of such action forcing the market below the conversion price. As it happened, the price went down to $53⅜ on March 14, 1947. Volume of trading in this stock increased during the call period as compared with the general market volume. Practically all of the 76,800 called shares were converted.

In the second quarter of 1947, during the period of a severe strike, the market price of the common stock fell to $49½; but by July 1, 1947, it had returned to $60–$60½ and the weekly volume of trading was in excess of 8,000 shares, which put the company in a position to force further conversion. Some of the directors strongly advised that the remainder of the stock be called, arguing that it was better to call all the shares at once to have the depressive effect on the price of the common over with in one operation. Other directors were hesitant, however, to incur the risk of having to secure $31,722,020 cash if the whole issue were called and conversion did not occur. They noted that the difference

between the effective call price of \$52.72 (\$52.25 plus accrued dividend of 47 cents per share) and the market price was only \$6.00 or \$7.00. The directors that favored calling all the issue felt that the answer to this problem was to refrain from calling any of the preferred until the market price of the common was high enough to assure a successful conversion of the whole issue. To them the essential thing was to do all the forcing in one operation. However, unanimous consent to this course of action could not be secured and a compromise was decided upon whereby 144,000 shares were called as of September 12, 1947. This involved a risk of \$15,048,000, an amount which the company could subtract from its net working capital of \$41,400,000 without imperiling its finances. Almost all the shares were converted into common, as the market price did not decline below \$56¾. This left about \$12,000,000, par value, of the original \$38,000,000 issue outstanding.

It was hoped to call the remainder of the issue shortly after the call in September, 1947. When the time came the directors did not think this was feasible because during the third quarter the company experienced lower earnings than were generally expected. The directors did not wish to take the responsibility of having the preferred shares converted before the earnings results were made public. Actually, publication of the third-quarter earnings data had little effect on the market. By this time, however, insurance companies had withdrawn temporarily from the purchase of new preferred stock issues, and the directors felt that there was no practicable method of securing long-term funds to replace cash used in the event that the market for the common suddenly declined after notice of call. Therefore, no further call was made upon the 3¼% preferred shares. As of December 31, 1947, 220,800 shares had been called for redemption, 220,049 of which were converted into common shares and 751 redeemed. In addition, 49,602 shares had been voluntarily converted at various times, leaving 109,958 shares still outstanding.

In the same period the directors were making plans to raise the remaining \$30,000,000 required for the expansion program. The idea of an issue of common was rejected. The directors did not wish to take any action which might depress the price of the common while conversion appeared likely.

The board absolutely refused to consider any further issue of debentures because of the risk involved. However, a suggestion to sell 3½% nonconvertible cumulative preferred stock was considered. It was ar-

gued that such a security would provide not only permanent capital but also a leverage factor for the benefit of the common shares. However, Ludlow, Milner & Co. pointed out that the investing institutions, the major market for such an issue, had become more selective regarding preferred issues in recent months and had been insisting on 2% sinking funds in ordinary preferred stock contracts. Several directors of Cellulose Corporation considered such a sinking fund highly irrational, for it would, in effect, put a maturity on the security so that the leverage advantage "would weaken and finally disappear." They also argued that such an arrangement would, with dividends, involve an "annual cost" of from 5% to 6%, which they considered altogether too much in the light of the credit standing of Cellulose Corporation.

In late October, 1947, the management felt out certain insurance companies to see whether a preferred stock on a 4% basis without a sinking fund would be acceptable. It was found that they would be interested in such an issue because of the rate quoted. The directors then decided to proceed on this basis, and so the company, through Ludlow, Milner & Co., immediately prepared to make a public offering of a straight preferred to yield about 4%. A registration statement was filed with the SEC early in November.

During the "waiting period" the market for new preferred issues became unsettled. This market was unusual. Although existing issues remained somewhat stable, new issues, although comparable, had to be sold at higher yields. An example of this unusual situation was Southern Utilities Corp. $4\frac{1}{2}$% preferred which had to be sold at par to yield 4.50%. Comparable outstanding issues were selling around a 3.90 basis. Similarly, Ludlow, Milner & Co. considered that it would have been difficult to sell a $30,000,000 Cellulose $4\frac{1}{4}$% issue at par, although an already outstanding Union Viscose & Chemical 4% preferred issue, which in many respects was comparable, was selling on the market at $103–$105. In addition, insurance companies were no longer interested in any preferred stock without a sinking fund. The directors of Cellulose, learning that a successful offering of an issue of the size contemplated could not be assured on what they considered reasonable terms, decided to postpone indefinitely the sale of straight preferred stock; and the registration with the SEC was withdrawn. Despite the delay in financing, it was necessary to make large commitments for machinery; and so Mr. Knowles arranged with a group of banks to borrow on five days' notice up to $12,000,000 on or prior to February 1, 1948, and an

additional \$18,000,000 on or prior to April 1, 1948, at $2\frac{1}{4}\%$ interest, the loans to mature January 2, 1951. The finance committee of the board of directors considered this a temporary expedient because they did not like "to finance bricks and mortar by means of three-year bank credit." On the other hand, the arrangement gave the management the satisfaction of knowing that, if necessary, they could wait up to three years to put this financing on a permanent basis. The company borrowed \$12,000,000 on this credit almost immediately, although it did not spend it.

Mr. Knowles, chairman of the finance committee of the board of directors of the Cellulose Corporation, had been a partner of Ludlow, Milner & Co. up to World War II, when he entered the government service in a high administrative capacity. After the war he devoted all his time to financial consulting. He was director of several large corporations.

Late in December, 1947, Mr. Knowles had several talks with the partners of Ludlow, Milner & Co. Feeling that he should put before the finance committee the alternatives that were open, he called a meeting for January 5, 1948. He opened this meeting with a summary of the financial program of 1946 and 1947. He then pointed out that world conditions were unsettled and that talk of war was becoming more and more common. Interest rates had risen; yet all the bankers he had talked with were agreed that money rates were still low with reference to long-run experience. Mr. Knowles felt that it would be wise for the company promptly to replace the three-year bank loan with permanent capital, for there was no reason to think that interest rates would be more attractive during the life of that loan.

Mr. Knowles presented five alternatives to the committee. The first was the current arrangement with the banks, the limitations of which he felt required no further amplification. Second, he was confident that the company could sell \$40 million of additional debentures to insurance companies and banks at very favorable rates, say 2.65%. This sale, however, would further modify the company's established policy to "leave the top open" for future needs. He pointed out that the total assets of the company had increased from \$14,600,000 in 1928 to \$165,000,000 in 1947 and profits before taxes had increased in the same period from \$1,291,000 to \$30,880,000. Because of this dynamic growth he thought it would be wise to refrain from selling senior securities if other alternatives were available.

One of the committee members expressed the thought, however, that the common shareholders might well complain that the management was being too cautious. He pointed out that other progressive and capably managed companies in the industry had financed a much greater proportion of their capital needs by debt. Another committee member countered this argument by remarking that the common stockholders, almost all of whom were small holders, had shown no signs of displeasure with the financial policies to date.

A third alternative was for the company to sell a \$30,000,000, 4% preferred stock issue. Mr. Knowles believed that there was still very much a buyers' market. He estimated that a 3% sinking fund would be required as compared to the 2% sinking fund considered in November, 1947, if the stock were to sell at a reasonable price. The discussion showed that some of the directors were strongly of the opinion that an issue with such a sinking fund was altogether too costly if 7% were required for dividend and sinking fund and, furthermore, would not meet their desire for permanent capital. It was little better than "a debenture issue with a tax disadvantage," as one director phrased it.

As a variation of this alternative Mr. Knowles said that Ludlow, Milner & Co. had advised him that a preferred issue could be sold without a sinking fund, but it would require a 4½% dividend. The bankers considered this out of line with the long-run credit rating of the company. One of the members of the finance committee noted that recently the Eastern Electric Company had successfully sold a \$7,500,000, 4.3% preferred issue without a sinking fund. Mr. Knowles informed him that the reason for the success of this issue was that it was relatively small and could be marketed without having to rely upon the life insurance companies to take any of it. The problem of placing an issue of \$7,500,000 was much simpler than that of placing one of \$30,000,000.

A common stock issue offered a fourth alternative. It had the advantage of being permanent capital as well as enlarging the base upon which bonds could be issued in the future. Mr. Knowles said that Ludlow, Milner & Co. would be willing to underwrite such an issue. With the current market \$58–\$60 for the common shares, he had talked with the bankers in terms of an issue at a price to the public of from \$47½ to not more than \$50. To this proposal one of the members raised the objection that he did not think it was good policy to sell shares at \$50 and invite criticism if the market should subsequently decline. Such a slump was possible, he thought, because in the fourth quarter of 1947 Cellu-

lose Corporation earnings had been poorer than investment publications had forecast. This member said that he favored waiting until the earnings had returned to "where they should be."

The fifth alternative, which Mr. Knowles favored, was to sell another issue of convertible preferred stock. Ludlow, Milner & Co. was confident that such an issue would have a strong appeal to investing institutions because it offered them an opportunity to participate in the common stock market. In fact, a convertible feature would be more acceptable than a sinking fund. In commenting on this alternative, Mr. Knowles said that he would consider it as a "dressed-up common," rather than a "sugared preferred" issue. In effect, it would enable the company to issue common shares at a favorable price and at the same time hedge against the effects of a drop in common stock prices during distribution or soon thereafter.

With reference to the various alternatives, Mr. Knowles presented a set of dilution tables, as shown in Exhibit 2, which dealt with financing the expansion by selling bonds, preferred stock, or common stock. He stated that he estimated that common shares would have to be sold at least for $47 in order to prevent any dilution of earning power if normal earnings were assumed to be $28,000,000. However, he thought that this level of earnings was very conservative.

Mr. Knowles said that the choice of convertible preferred presented some complex problems. With straight preferred issues the major factor of the yield basis required the adjustment of price and dividend rate. The matter of the proper yield basis, of course, was not simple. If it resulted in a price two points too low, much demand would be created and so turn the stock into a "hot issue," which would get into speculative hands rather than remain placed with investors. On the other hand, if the price were two points too high, the issue would probably have little appeal. With a convertible issue there were three factors: price, dividend rate, and conversion price. The accepted range for conversion was between 5% and 10% above the market of the common stock at the time of offering. Generally speaking, if the conversion price were set relatively high, making the possibility of conversion remote, the yield basis would have to be set higher. Contrariwise, if a low conversion rate were set, making possible profitable conversion in the near future, the yield rate could be lower. In this case, the issue would tend to appeal to investors with a "common stock outlook." However, if the conversion price were set too close to the market, the issue might go largely into speculative

hands. If speculators forced the price up shortly after the stock was issued, common stockholders might take the price increase as evidence that the issue had been underpriced and they might, therefore, criticize the management if they had not been given prior right to subscribe to the issue.

Again, if the conversion price were set at a low level it might tend to depress the long-run price of the common. This was so because once the market price of the common got above the conversion price there was always a potential danger of large-scale conversion. Inasmuch as during 1947 the common had always been subject to this threat, Mr. Knowles felt that it was deserving of some relief for a while. He thought that it might bring disfavor on the management if, each time Cellulose stock showed a strong bullish tendency, the directors took action which forced the market to retreat.

As a matter of detail, Mr. Knowles said that any preferred issue should be so set up as to avoid any confusion between it and the $3\frac{1}{4}$% preferred, of which a small amount was still outstanding. The dividend rate and the conversion price should differ in the two issues. Also, attention would have to be given as necessary to the clause in the existing

Exhibit 1

CELLULOSE CORPORATION

BALANCE SHEET AS AT SEPTEMBER 30, 1947

(Dollar figures in thousands)

ASSETS		
Current		$ 70,954
Investments and miscellaneous assets		3,491
Land and plant	$141,906	
Less: Depreciation	54,450	87,456
Deferred charges		1,987
		$163,888
LIABILITIES		
Current		$ 17,546
Advances—noncurrent		425
Debentures, 2.65% due 1971		36,000
Pension reserve		7,042
Capital stock and surplus:		
Preferred, $3\frac{1}{4}$%, $100 par, convertible, outstanding 122,871 shares	$ 12,287	
Common, no par value, outstanding 5,077,796 shares	25,388	
Surplus	65,200	102,875
		$163,888

Chart 1

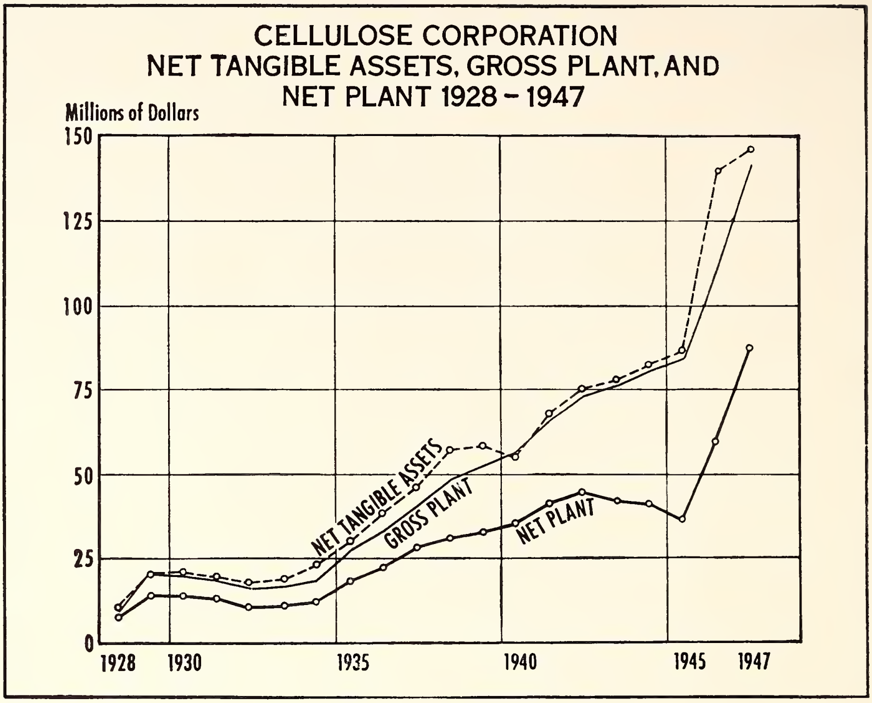

Chart 2

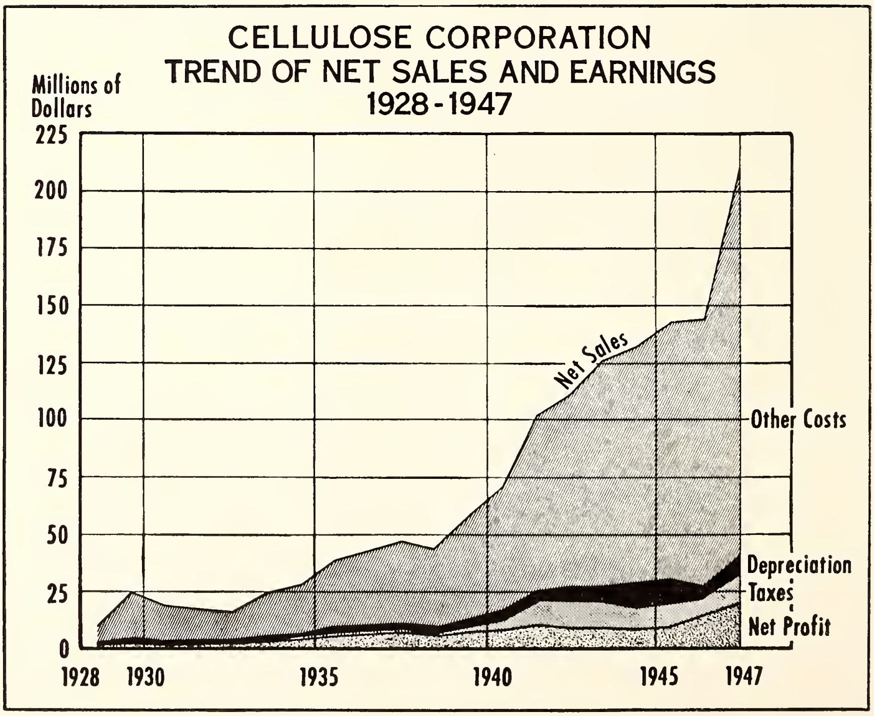

Chart 3

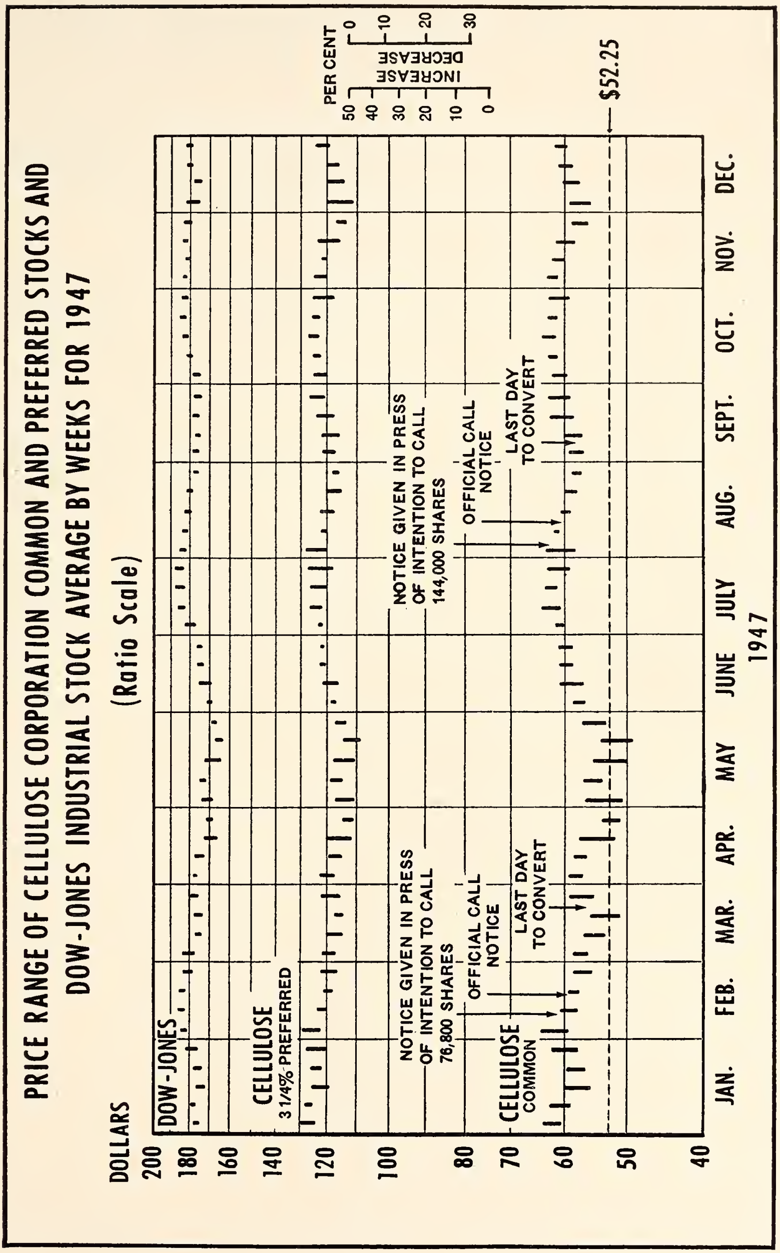
PRICE RANGE OF CELLULOSE CORPORATION COMMON AND PREFERRED STOCKS AND DOW-JONES INDUSTRIAL STOCK AVERAGE BY WEEKS FOR 1947
(Ratio Scale)
DOLLARS
200
180
160
140
120
100
80
70
60
50
40
DOW-JONES
CELLULOSE
3 1/4% PREFERRED
CELLULOSE
COMMON
NOTICE GIVEN IN PRESS OF INTENTION TO CALL 76,800 SHARES
OFFICIAL CALL NOTICE
LAST DAY TO CONVERT
NOTICE GIVEN IN PRESS OF INTENTION TO CALL 144,000 SHARES
OFFICIAL CALL NOTICE
LAST DAY TO CONVERT
$52.25
PER CENT
INCREASE
DECREASE
50
40
30
20
10
0
0
10
20
30
JAN.
FEB.
MAR.
APR.
MAY
JUNE
JULY
AUG.
SEPT.
OCT.
NOV.
DEC.
1947

Exhibit 2

CELLULOSE CORPORATION

EFFECT OF DIFFERENT FINANCING PROPOSALS TO RAISE $30,000,000 ON COMMON STOCK EARNINGS, ASSUMING ALL $3\frac{1}{4}$% PREFERRED HAS BEEN CONVERTED

(Dollar figures in thousands)

Present:					
Assumed earnings available to present common shares	$20,000	$25,000	$30,000	$35,000	$40,000
Taxes at 40%	8,000	10,000	12,000	14,000	16,000
Available to common	$12,000	$15,000	$18,000	$21,000	$24,000
Earnings per share—after all $3\frac{1}{4}$% preferred converted—5,323,538 shares	$2.25	$2.82	$3.38	$3.94	$4.51
Plan A—2.65% debentures:					
Above assumed earnings	$20,000	$25,000	$30,000	$35,000	$40,000
10% return on $30,000,000	3,000	3,000	3,000	3,000	3,000
Less: 2.65% on $30,000,000 debentures	795	795	795	795	795
	$22,205	$27,205	$32,205	$37,205	$42,205
Taxes at 40%	8,882	10,882	12,882	14,882	16,882
Available to common	$13,323	$16,323	$19,323	$22,323	$25,323
Earnings per share—after all $3\frac{1}{4}$% preferred converted—5,323,538 shares	$2.50	$3.07	$3.63	$4.19	$4.76
Plan B—4% preferred:					
Above assumed earnings	$20,000	$25,000	$30,000	$35,000	$40,000
10% return on $30,000,000	3,000	3,000	3,000	3,000	3,000
Taxes at 40%	9,200	11,200	13,200	15,200	17,200
	$13,800	$16,800	$19,800	$22,800	$25,800
Less: 4% preferred dividend	1,200	1,200	1,200	1,200	1,200
Available to common	$12,600	$15,600	$18,600	$21,600	$24,600
Earnings per share—after all $3\frac{1}{4}$% preferred converted—5,323,538	$2.37	$2.93	$3.49	$4.06	$4.62

Plan C—$4\frac{1}{2}\%$ preferred:					
Above assumed earnings	$20,000	$25,000	$30,000	$35,000	$40,000
10% return on $30,000,000	3,000	3,000	3,000	3,000	3,000
Taxes at 40%	9,200	11,200	13,200	15,200	17,200
	$13,800	$16,800	$19,800	$22,800	$25,800
Less: $4\frac{1}{2}\%$ preferred dividend	1,275	1,275	1,275	1,275	1,275
Available to common	$12,525	$15,525	$18,525	$21,525	$24,525
Earnings per share—after all $3\frac{1}{4}\%$ preferred converted—5,323,538 shares	$2.35	$2.92	$3.48	$4.04	$4.61
Plan D—common stock at $50:					
Above assumed earnings	$20,000	$25,000	$30,000	$35,000	$40,000
10% return on $30,000,000	3,000	3,000	3,000	3,000	3,000
Taxes at 40%	9,200	11,200	13,200	15,200	17,200
Available to common	$13,800	$16,800	$19,800	$22,800	$25,800
Earnings per share—after all $3\frac{1}{4}\%$ preferred converted plus 600,000 new shares—5,923,538 shares	$2.33	$2.84	$3.34	$3.85	$4.36

preferred contract, which read as follows: "The conversion price shall be reduced if the company issues any additional shares of common stock [other than shares of common stock issued upon conversion of shares of Cumulative Preference Stock, $3\frac{1}{4}\%$ series], without receiving therefor a consideration per share at least equal to the conversion price then in effect, and the conversion price shall be increased if the company combines its outstanding shares of Common Stock."

Market conditions were described in *Business Week,* January 10, 1948, as follows:

> One reason for the better feeling among underwriters is the behavior of the corporate bond market. . . . Apparently the corporate market took its medicine all in one dose. Since the first drop it has tended to firm up.
>
> Another and more important factor: Right or wrong the trade has become convinced that a huge amount of invested institutional funds has built up in recent weeks. Bond men are confident that the pressure of these funds will break the buyers' strike of life insurance companies and other institutions.

Jay Textiles, Inc.

Jay Textiles, Inc., operated several cotton and rayon textile mills in a southern state. These mills were first established by separate interests. They were consolidated under single ownership during the 1920's. The consolidated company was reasonably prosperous until the depression of the 1930's, when it found itself under financial strain, as did most concerns in the textile industry. Fortunately, Tarheel Bank and Trust Company, the company's bank, gave assistance in the form of short-term renewable loans as necessary during this period; and so the company continued to operate without a financial crisis. This strong support was accorded in part because the bank considered the company one of the basic industries in the state and felt that by assisting Jay it was at the same time promoting the general welfare of the community.

Improved earnings during the war, shown in Exhibit 1 (p. 175), and the optimistic outlook for the textile market caused Mr. Bergen, the president of the company, to propose to the bank in 1945 a scheme of refinancing the floating debt. He also planned a modernization program which it was felt would put the company on a firm and profitable basis. Engineering studies indicated the need of spending $7,300,000 over a three-year period. About $1,200,000 was the minimum for 1946.

When the refinancing plan was agreed upon in 1945, it was the intention of the directors to refund the short-term bank debt of $5,000,000 by selling serial notes or debentures to life insurance companies. A committee appointed by the directors on December 3, 1945, to investigate such possibilities reported that insurance companies were reluctant to purchase the obligations of textile companies because of the poor earnings record of the industry and its cyclical nature. The committee recommended the acceptance of an alternative proposal advanced by the bank but emphasized that such a proposal was to be construed purely as an interim expedient while a more permanent and favorable form of capitalization was sought.

The Tarheel Bank and Trust Company had offered the following arrangement:

1. \$1,750,000, $2\frac{3}{4}\%$ unsecured loan, to be repaid in \$100,000 semiannual installments, commencing one year after date.

2. \$3,250,000, 3% unsecured loan calling for sinking fund payments, beginning with 1946 earnings, of 40% of the annual profits in excess of \$1,000,000, but less than \$2,000,000, and 20% of the annual profits in excess of \$2,000,000. The sinking fund would be due March 1, annually, but only from March 1, 1947.

The bank, in offering the above rearrangement of its loan, emphasized that the terms of the 3% loan were designed to force the company to retire it as soon as possible. It stated that either loan could be retired in whole or in part at any time without penalty.

The directors agreed to the proposal, and the loan agreement was signed on December 22, 1945.

At a meeting of the directors held late in December, Mr. Levin, treasurer of the company, was asked to investigate ways and means of refunding these bank loans with permanent capital at the earliest opportunity.

At the close of 1945, the outlook for the cotton and rayon industry was particularly bright. Stocks of goods in distribution channels were largely depleted, and consumer buying power gave every indication of remaining at a very high level for many months. The historical problem of the textile industry, that of overcapacity, appeared to have been largely alleviated. The number of spindles in operation in 1925 had been 37,872,000, while in 1944 the reported number was 23,108,000, a decrease of 39%. Furthermore, foreign competition was negligible because of the dislocation caused by the war in Europe and Japan. The prospects of an increased and more efficient labor supply and the possibility of obtaining new and faster machinery were additional favorable factors. Such factors, coupled with the elimination of the excess profits tax, made the future of the cotton industry appear particularly favorable.

Conditions in the securities markets at the end of 1945 and early 1946 were "strongly bullish." The most outstanding feature of this period was the intense demand for investments, which resulted in driving down the yields on securities to abnormally low levels. Furthermore, the investing public was showing less and less discrimination in selecting securities. This development was reflected in the lessening differential in yields between different grades of securities.

Quotations (paraphrased), taken principally from *Barron's,* will be

inserted in this case at certain points to enable the reader to gain "a feel of the market" as the case progresses. The first of these follows:

January 14, 1946

In the greatest surge of strength since the current phase of the rise began in the week after V-J Day, all three major groups of stocks—industrial, rail and utility—pushed last week to new high prices. . . . On all counts, activity and extent and length of rise—the advance of last week is noteworthy in the annals of the long bull market. . . . Moreover, in the upheaval of prices a great change has occurred in the yields. When the bull market commenced, the industrial stock average yielded 7⅝% and the rails 8½%, against a rate of 2¾% from prime bonds. In other words, there was a spread in favor of industrial stocks of nearly 5%, and for rails 5¾%. By July, 1943, the industrial yield was down to 4⅜%, with the advantage over bonds 1⅞%. Now, above 200, the industrials yield 3⅜%, or ¾ of 1% more than bonds, while the rails give 4¼%, or 1⅝% more than prime bonds. The evolving story of yields indicates how far the market has proceeded in discounting the peace boom.

January 28, 1946

Record high prices being established for both government and corporate bonds are furnishing convincing proof that the country actually is running short of places to put investable funds.

March 4, 1946

Only twice before in 15 years has the stock market declined so much in a single session as the 8.39 point break in the Dow-Jones industrial average which ushered in the last week of February. . . . Recovery in stock prices which set in at mid-week left unanswered the question as to the cause of this decline.

March 7, 1946

M. Lowenstein & Sons, Inc.

75,267 shares, 4¼% preferred, $100 par, was offered today at $104 per share (proceeds to company $101.50) by Eastman Dillon & Company.

Following the instructions of the directors as given in the meeting of December 28, 1945, Mr. Levin submitted the following report for discussion at the directors' meeting of March 21, 1946. The report included the balance sheet of December 31, 1945 (shown in Exhibit 2). The text read:

MEMORANDUM

A—Factors to Be Considered and Assumptions Used in Financing Study

1. *Working Capital*

During the fall of 1945, Jay was operating with a net working capital of approximately $10,550,000. Because of capital expenditures this was subsequently

reduced to about $9,730,000 as at December 31, 1945. As of February 23, 1946, it had increased to about $9,850,000 as a result of two periods of earnings with relatively small capital expenditures.

As at December 31, 1945, cash balances stood at $2,437,441. While this appeared to be large, it is being rapidly absorbed by increases in other current assets. As has been expected, it has been melting away and in all probability will not accumulate rapidly, if in fact it holds its own. The existence of this excess cash and its availability to absorb inventories, etc., *does not increase net working capital.*

As a convenient yardstick, sales of $50,000,000 for the year will represent a daily turnover at the rate of $200,000 a day for the approximate 250 days of operations. The rapidity with which a million of cash can disappear with this volume of business is readily apparent.

A specific item which may absorb a very substantial amount of cash is the expansion of the dress goods program in which the turnover is slower and the cash tie-up relatively larger.

In general, we anticipate a further rise in the cost level. This will be reflected gradually in the receivables-inventories block of assets which stood at $8,611,000 at December 31, 1945, and is now about $9,780,000. We also know that the volume of business is on the upswing with the increasing number of employees at work in the mills. This will also mean an increase in the receivables-inventories block of assets.

My guess, which is all that it can be at this stage, is that Jay should have at least 11 millions of working capital, preferably 12 millions, if it is to operate freely at this cost level and keep out of the banks.

For the year 1946 I therefore include $1,700,000 for additional working capital.

2. *Note Maturities and Sinking Funds*

The only maturity in 1946 is $100,000 on the 2¾% serial notes on December 22.

The contingent sinking fund on the $3,250,000 note is not payable until March, 1947. The amount to be paid is predicated upon earnings and must be provided for out of current earnings. In order to have figures to work with, assume 1946 earnings to be $2,800,000 after all charges. The contingent sinking fund would be $560,000, which together with the fixed maturity would pull $660,000 out of our cash position.

On the other hand, if we refund the two bank notes during 1946, it will require $5,000,000. The bank does not require a premium for retiring the loan before maturity, nor is it anxious to have any prepayments. I have just checked this with Mr. Randall at the bank.

3. *Capital Expenditures*

The amount to be spent during 1946 is dependent upon the availability of machinery and materials rather than on the desirable and potential field for making additions and replacements in the five mills.

The amount to be spent in any event is controllable in some degree and can be reduced or expanded to fit our pocketbook.

In order to develop a refinancing program, assume an aggregate of $1,200,000 of capital expenditures during 1946.

4. *Dividends*

In accordance with our policy of paying $1.50 per share per annum on the common, we must set aside $652,500.

5. *Cash Availability from Operations*

Earnings assumed earlier		$2,800,000
Depreciation (at rate allowed by Bureau of Internal Revenue)	$ 361,000	
Depreciation (additional necessary for adequate replacement)	261,000	622,000
Cash accruing from operations		$3,422,000

B—SUMMARY OF FINANCIAL POSITION

(A) *Assume no refinancing in 1946*

1. Provide for additional working capital		$1,700,000
2. December 22 note maturity	$ 100,000	
Contingent sinking fund	560,000	660,000
3. Capital expenditures		1,200,000
4. Dividends at rate of $1.50 for the year		652,500
		$4,212,500
5. Cash from operations:		
Assumed earnings	$2,800,000	
Depreciation charges	622,000	3,422,000
Indicated shortage		$ 790,500

Comment: The indicated shortage approximates the note maturity and contingent sinking fund. The borrowing of this amount as a current bank loan for working capital has the effect of substituting current debt for the long-term debt.

(B) *Assume refinancing in 1946*

1. Provide for additional working capital		$1,700,000	
2. Note maturity and sinking fund		(Eliminated)	
3. Capital expenditures		1,200,000	
4. Dividends at rate of $1.50 for the year		652,500	
		3,552,500	
5. Retirement of bank loans		5,000,000	$8,552,500
6. Cash from assumed earnings	$2,800,000		
7. Cash from depreciation charges	622,000		3,422,000
Indicated need			$5,130.500

Comments: The above figures are assumptions to establish a general financial pattern and demonstrate the end results simply. The basic assumption is that we are faced with a year of good business with high earnings. The corollary of this assumption is more working capital, a heavy sinking fund accrual, and pressure to improve the productive plant.

Assuming that cash is not developed from current operations in an amount sufficient to provide for all the desirable objectives, we have two alternatives: (*a*) to cut back the objectives to fit our pocketbook, (*b*) to borrow. While the latter is entirely in order, it has the effect of shifting a piece of the long-term bank debt to short-term bank debt.

Assuming that cash is not produced from a refinancing operation in an amount sufficient to clear the financial decks, we are again left facing the same alternatives of where to cut and at what point to borrow. The latter alternative is, however, less objectionable after the elimination of all of the long-term bank debts.

A partial financing of the long-term bank debt does not solve the problem from the company's viewpoint. If anything, it leaves the company with a poorer financial setup, consisting of current bank loans, serial bank debt, a debenture or preferred issue of some kind, and common stock. Two layers of bank debt ahead of a junior issue would not make the junior issue a prime piece of paper, and the existence of three capital layers ahead of the common would not be desirable for the common stock.

Conclusion: If financing is to be undertaken, it should be in a minimum amount of $5,500,000.

C—Alternative Methods of Financing

There are innumerable combinations possible, and only the major alternatives are commented upon.

The assumptions are:

A. We want to raise about $5,500,000 of cash if we are going after public financing.
B. The financing should be designed to point towards an eventual end result of an all-common stock capitalization.

The two extreme possibilities are:

1. *Debt financing*. This can be in the form of long-term mortgage bonds, shorter term debentures of some kind, still shorter term serial notes.

   Comments: Creating $5,500,000 of debt to replace $5,000,000 of existing debt is not progressive in itself. While a new form of debt would have a longer maturity than the 8½-year bank loans now existing, the inherent problems of sinking fund or serial payments would still be with us, although at a possibly slower rate. Publicly held debt obligations may or may not be an advantage in contrast with having to work out any problems with one friendly creditor.
2. *Common stock financing*. This is an ideal method in theory. Assuming stock salable at $40 a share and the issuance of additional shares on the basis of one new for each three presently outstanding (or 145,000 new shares), this would produce roughly $5,800,000 net of cash, a very desirable result.

Comments: The market for Jay stock fluctuated widely in 1945. Since January 1, the market has climbed from about $34\frac{1}{4}$ bid to about 41. Problems of underwriting, voting, dilution, and cost of the additional capital are obviously of moment.

Conclusions: I advise against either of the extreme methods at this time.

Intermediate Methods

Create a preferred stock, the major alternatives being a straight preferred or a convertible preferred.

Straight Preferred. From the standpoint of financial setup a great improvement over debt. From the viewpoint of the common, it creates a senior charge higher than that now existing and the preferred dividends would not be a tax deduction as is the interest on the loan. This is not a monumental difference, and the additional working capital and elimination of debt are contra considerations.

Other considerations are: call price on such an issue, possible retirement funds from operations, voting rights in the event of dividend accruals, possible limitations in regard to incurring debt and maintenance of working capital position as they might affect the paying of common dividends.

Convertible Preferred. This may offer somewhat greater advantages than the straight preferred, more particularly as to price, voting rights, restrictions, and retirement provisions. It also points directly towards the end objective of a common stock capitalization.

The objections at this time are somewhat similar to those applying to a common stock issue, although in a much less intense degree. Another general problem, and one that will always exist, is that of setting the conversion rate, a formula which necessarily looks into the future.

Possible Alternative. The sale of $5,500,000 straight preferred, and calling it later through the sale of additional common stock. Obviously more expensive, as it means two steps.

Conclusions: The relative terms which could be traded out with an underwriting group might be the decisive factors as between a straight or convertible preferred. We are in a position to create, within reason, the type of stock best fitted to our requirements.

As between the two broad types, my preference is for the convertible preferred.

Possible Combination of Financing

The problems of raising about $5,500,000 have been the subject of extended informal discussions. These have included the possibility of raising part of the cash through the sale of some type of preferred, say $3,500,000, in order to reduce the balance to be raised through the sales of common. As the discussions have progressed, the enthusiasm for this type of package has steadily decreased, the selling of the additional common being the drawback.

Conclusion: I recommend against undertaking this general form of package financing.

AUGUST LEVIN, *Treasurer*
Submitted March 21, 1946

After considering the report, the directors agreed with Mr. Levin that the problem should be given more intensive study during the next few weeks. Mr. Troster, representing Ford & Troster, Inc., on the board of directors,[1] questioned the advisability of issuing convertible preferred. He favored a "straight preferred" because he thought that in a couple of years the earnings of the company would prove so satisfactory that a much higher price could be secured for the common by selling it directly than would be possible by selling convertible preferred at the current time. He explained that, at the current time, it might be possible to put out preferred shares convertible on a three-for-one basis. This would mean that if the shares were converted the company would be selling the common shares for approximately $35. If, however, in two years' time common shares were sold directly, a price of $45 or $50 might be obtained, resulting in a gain which would far outweigh any current advantage in price between a convertible preferred and a straight preferred. Mr. Repucci, the representative of Mid-Central Securities Corporation, agreed with Mr. Troster's argument and proposed that the matter should be studied further by Mr. Levin.

One of the directors, Mr. R. C. Milner, advocated a bond issue, arguing that it would yield a saving of at least $\frac{1}{2}$ of 1% in interest as well as a saving in taxes. However, the other directors seemed to feel that the industry was too cyclical to incur any fixed charges such as would result from such an issue. Mr. Bergen proposed that Mr. Levin be authorized to open negotiations with Ford & Troster, Inc., in order to put forth concrete proposals for consideration at the next board meeting. After Mr. Troster and Mr. Repucci absented themselves, the board unanimously concurred with Mr. Bergen's motion.

March 27, 1946
Hollingsworth & Whitney Co.

42,000 shares, $4 preferred, was offered today at $105 (proceeds to the company $103 per share) by Paine, Webber, Jackson & Curtis and Harriman Ripley & Company.

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[1] During 1943 two large holdings of Jay common shares were redistributed through the houses of Ford & Troster, Inc., and the Mid-Central Securities Corporation. At that time it was arranged that each of these houses should have a representation on the board of directors.

Ford & Troster, Inc., was a small investment house that had its principal customer connections in a three-state area around Atlanta. It had acted as principal underwriter for a number of successful industrial issues, forming successful selling groups extending over a much larger region. The Mid-Central Securities Corporation was one of the largest originating houses, participating in many distributions on a nation-wide basis.

Mr. Levin and Mr. Bergen gave the refinancing problem much consideration during the next week, both coming to the conclusion that Mr. Troster's argument had much validity and that they should seek financing by means of straight preferred stock.

April 8, 1946

Biggest advance since the first recovery week of March 4 took place in the stock market last week. There also occurred the largest single gain, on Wednesday, since the low levels of February 26.

. . . But the most dramatic evidence of the intensity of the public demand for stocks is found in the extraordinary premiums placed upon two public offerings. Common stock of Alexander Smith & Sons Carpet, publicly financed for the first time, rose from an offering level of 31 to 41, and Publicker Industries common (industrial chemicals and alcoholic beverages) reached 31 in the outside market, as compared with the initial figure of 23.

April 15, 1946

Another burst of strength last week carried industrial stocks to a new high level for the four-year rise.

On April 15, 1946, Mr. Levin had lunch with Mr. Oliver, who was in charge of the buying department of Ford & Troster, Inc. Mr. Oliver agreed completely with Mr. Troster's reasoning about the conversion privilege. However, he did not think that it would be wise to attempt to sell $5,500,000 preferred, being confident that both the Mid-Central Securities Corporation and Ford & Troster, Inc., could place $4,000,000 in "strong hands." To place $5,500,000 for such a company as Jay would mean that some reliance would have to be put on the speculative element of the market, while it was preferable to sell only to those individuals seeking income investments. Mr. Oliver also explained that the dividend rate of the preferred stock, the price, and the spread allowed to the underwriters would depend on market conditions at the time of initial offering. Naturally, if the market was strongly "bullish," a much better rate, price, and spread could be given than if the market was "cautious" or still again "bearish."

Mr. Oliver pointed out to Mr. Levin that as far as details of such a preferred issue were concerned the style factor entered into the framing of them just as surely as it did into dress designing. Each preferred stock had variations in order to meet the peculiarities of the industry and company concerned, but the general outlines of such provisions were the same. The current preferred stock style set approximate limits as to what extent these numerous details were subject to negotiation. Mr.

Oliver then described in broad terms the current market attitude toward textile securities and what might be required "to take the security out the window" rather than having it left "on the shelves." Mr. Oliver finally urged Mr. Levin to expedite the negotiations as much as possible, for the market appeared to be developing signs of instability.

After considering the foregoing discussion, both Mr. Levin and Mr. Bergen concluded that an issue of $4,000,000 was worse than none at all. If this were netted by a preferred issue, an additional $1,500,000 would have to be raised by some other means, probably bank loans. Both were agreed that it would be better to stay with a friendly bank until the market was receptive enough to take up the $5,500,000 desired.

The following week, on April 23, Mr. Levin and Mr. Bergen met Mr. Oliver in the latter's office. Mr. Oliver brought out from his files several prospectuses of recent textile preferred issues which served as a basis for discussion of the possible provisions in the proposed Jay issue. Before the discussion had developed very far, the problem of the amount of such an issue came to the forefront. Mr. Levin pointed out that an issue of $4,000,000 would not be a solution to Jay's problem but would only complicate the financial setup of the company. Mr. Oliver replied that such a large issue would be extremely difficult to sell at a satisfactory price. Then Mr. Bergen suggested that perhaps the idea of putting out a preferred issue was premature at this time and that it would be more satisfactory to stay with the banks. He went on to say that in recent discussions with Mr. Randall of the Tarheel Bank and Trust Company he was assured that the bank, while recognizing the desirability of permanent financing, did not wish to convey the impression of trying to force the matter. It was quite willing to continue the existing arrangement as long as desired. The discussion ended with Mr. Oliver's promising to draw up tentative provisions for the proposed issue and a comparison of the various recent issues of textile preferreds. They hoped this procedure would speed the negotiations by enabling specific points to be discussed and decided upon.

April 26, 1946
Burlington Mills Corporation

24,433 shares (being the unsubscribed portion of 100,000 shares offered to common shareholders) 3½% convertible 2d preferred was offered today at 104 by Kidder, Peabody & Company.

On April 26, Mr. Levin received by mail from Mr. Oliver the outline of the proposed preferred provisions (shown in Exhibit 3), and the

comparison of recent preferred issues (given in Exhibit 5). In a covering letter, Mr. Oliver stated that he had inserted the details on Jay on the assumption of a $4,000,000 issue, realizing, however, that the matter had not been finally decided upon. Exhibit 4 shows the price range of Jay common stock from December, 1945, to April, 1946.

On April 27, 1946, Mr. Oliver and Mr. Repucci called on Mr. Levin. Mr. Levin stated at this time that both he and Mr. Bergen were firmly convinced that it would be impractical to contemplate a preferred issue of $4,000,000. After having considered the matter in detail again, both parties finally agreed to continue negotiations on the basis of a $5,000,000 issue.

Mr. Oliver said that the proposed provisions would stand as a basis for discussion. He said that he liked to set up a plan so that "a preferred should always be as strong as when it was first issued." Mr. Bergen and Mr. Levin did not choose to question the provisions until they had more time to study each item. The rest of the day was spent in showing Mr. Oliver and Mr. Repucci the various plans.

April 29, 1946

Most observers were impressed by the purchase of a big insurance company, on a 2.55% basis, of $32 million Philip Morris 2⅝% debentures, which the company, following the disclosure of a collapse of earning power, had been unable to market in early February.

Exhibit 1

JAY TEXTILES, INC.

OPERATING RESULTS 1937–1946

(Dollar figures in thousands)

Year	*Net Sales*	*Net Profit before Interest and Taxes*	*Net Profit after All Charges*
1937	$19,670	$ 742	$ 112
1938	15,195	1,119[d]	1,731[d]
1939	20,278	97	557[d]
1940	20,393	135[d]	926[d]
1941	32,444	3,403	2,195
1942	41,993	4,333	1,443
1943	39,195	4,275	1,152
1944	40,340	4,891	1,065
1945	36,783	3,654	957

[d] Loss.

Exhibit 2

JAY TEXTILES, INC.

BALANCE SHEET, AS AT DECEMBER 31, 1945

(Dollar figures in thousands)

ASSETS

Current assets:	
Cash	$ 2,437
U.S. Treasury notes in excess of tax estimate	217
Accounts receivable—net	904
Inventories	7,707
	$11,265
Investments	249
Fixed assets—net*	5,424
Deferred charges	187
	$17,125

LIABILITIES

Current liabilities:	
Accounts payable	$ 901
Accrued payroll	220
Other accruals	414
Provision for taxes—less treasury notes	3
	$1,538
Bank loans	5,000
Reserve for contingencies	166
Capital stock—common, 435,000 shares	4,350
Surplus:	
Capital	21
Paid-in	5,134
Earned	916
	$17,125

* Reserve for depreciation, $4,519.

Exhibit 3

JAY TEXTILES, INC.

OUTLINE OF PROPOSED PREFERRED STOCK PROVISIONS PREPARED BY FORD & TROSTER, INC.

Preferred Stock to have no pre-emptive rights, to be fully paid and nonassessable.

Call Prices—Call price $5 per share above the initial public offering price for five years, thereafter $3 per share above such price. For the Sinking Fund, call price $2 above the initial public offering price for five years and $1 above the public offering price thereafter. Accrued dividend to the date of call to be added to the above premiums in every case.

Exhibit 3—Continued

Dividend Restrictions—No dividends on or redemption of junior stocks unless:

A. Dividends and Sinking Fund payments are all up to date.
B. Unless paid out of surplus earned after January 1, 1946, and then only if this earned surplus after such payment is at least 25% of the preferred stock outstanding.
C. Unless net tangible assets are at least 200% of the preferred stock outstanding and funded debt.
D. Current assets 150% of current liabilities after payment of dividends.

Voting Rights—Preferred stock to elect—

A. Two additional directors if four quarterly dividends are in arrears or if a Sinking Fund payment is in arrears for six months.
B. A majority of the directors if eight quarterly dividends are in arrears or if Sinking Fund payments are in arrears for eighteen months.

. . . .

Two-third vote of preferred stock required to—

A. Create any debt maturing more than one year from issue.
B. To issue preferred stock having priority to the present stock.
C. To sell, liquidate or lease substantially all the property of the company.

. . . .

Majority vote of preferred stock required to—

A. Issue any additional preferred stock on a parity with this preferred stock and then only if after issuance net tangible assets are at least 200% over all the preferred and funded debt outstanding and combined annual interest and preferred dividend requirements are earned four times.

Sinking Fund—Annual payments of 1% (until present term debt is retired) of the largest amount of preferred stock theretofore outstanding. After retirement of term debt annual sinking fund payments of 4% of the largest par value of preferred stock theretofore outstanding. Sinking Fund payments may be made in preferred stock bought in the market by the company but not at a cost in excess of the Sinking Fund call price.

Exhibit 4

JAY TEXTILES, INC.

PRICE RANGE OF COMMON STOCK QUOTATIONS

	High	*Low*
December, 1945	32¼	31½
January, 1946	35	34¼
February	37¾	36¾
March	42	41
April	45	43½

Exhibit 5

JAY TEXTILES, INC.

COMPARISON OF TEXTILE PREFERRED STOCKS PREPARED BY FORD & TROSTER, INC.

(Dollar figures in thousands)

	Jay	*M. Lowenstein & Sons, Inc.*	*Kendall Company*
Net sales, 1945	$ 36,783	$49,731	$ 49,616*
Net profit, 1945	957	1,717	731*
Current assets	11,265	16,280	15,924*
Current liabilities	1,538	3,667	3,336*
Working capital	$ 9,727	$12,613	$ 12,588*
Debt			5,000
Preferred	$ 4,000	$ 8,000	$ 4,000
Common, no. of shares	435,000	1,000,000	400,000
Market value common	$ 16,530	$35,000	$ 12,000
Book value preferred	$361	$265	$267
Net sales times debt and pfd.	9.2	6.2	5.5
Net profit % of net sales	2.6%	3.5%	1.5%
Working capital per share pfd.	$243	$158	$187
Earned per share preferred (annual basis):			
1945	$23.92	$21.50	....
1944	26.62	17.70	$18.30
1943	28.80	24.10	23.60
1942	36.75	28.00	24.20
1941	54.87	29.60	28.80
Sinking fund		3%	1%–1960†
Issued at—when		104(3/7/46)	103(4/1/45)
Call price—until		108(12/31/47)	108(4/1/55)
Then—until		107(12/31/49)	
Sinking fund—call price		104	105(4/1/55)
Market‡		104 3/4	108
Dividend rate		4¼%	$4.50
Yield		4.05%	4.17%

Hollingsworth & Whitney	*Burlington Mills*	*S. D. Warren Company*	*Berkshire Fine Spinning Assoc., Inc.*
$ 17,923	$108,199	$ 15,895	$ 36,143
642	4,993	461	1,813
8,224	37,590	8,647	12,512
3,217	9,168	1,537	1,760
$ 5,007	$ 28,422	$ 7,110	$ 10,752
450		3,620	
$ 4,200	$ 15,000—4% $ 5,000—3½%	$ 3,000	$ 7,108
388,000	1,721,776	101,387	457,126
$ 12,028	$ 44,766	$ 5,880	$ 17,827
$ 452	$ 245	$ 327	$ 215
3.8	5.4	2.4	5.1
3.6%	4.6%	2.9%	5.0%
$ 99	$ 142	$ 116	$ 152
$15.30	$25.00	$15.40	$25.50
14.30	19.90	17.90	22.60
17.40	19.00	17.10	24.30
22.30	17.20	12.30	26.80
31.30	15.90	26.00	26.00
2½%	2%	2%	
105(3/27/46)	104(7/2/45)	101.50(12/11/45)	By recapitalization
109(1951)	108(1946)	106.50(1950)	105
108.5(1953)	107.50(1947)	105.50(1955)	. . .
107(1953)	104	104(1950)	
105 5/8	99, 89½	103½	126
$4.00	4%, 3½%	$4.50	$5.00
3.79%	4.03%, 3.91%	4.35%	3.97%

* 1944.
† 1% through 1960, 2% thereafter.
‡ Sale price, or average of bid and asked price.

Dixley Paper Company (B)

On February 5, 1946, the executive committee of the Dixley Paper Company decided, subject to vote of the directors and stockholders, to issue 50,000 shares of $4.00 preferred stock on the terms[1] outlined by George Holmes, company treasurer. Word of this action soon spread, and Mr. Holmes received numerous visits from underwriting representatives.

As Mr. Holmes had anticipated, his proposed terms were not well received. Nevertheless, a number of firms betrayed obvious interest, and the trend of their offers reinforced Mr. Holmes's belief that his terms would be accepted before very long. Accordingly, preliminary discussions with counsel were started with a view toward preparing the legal provisions pursuant to which the stock would be authorized and issued.

On February 14, Mr. Holmes received a visit from John Wendell, an officer of the Massachusetts Mutual Society for Insurance on Lives. Mr. Wendell stated that he had heard that the Dixley Paper Company was contemplating a public offering of preferred stock. Mr. Holmes confirmed that such was indeed the case and outlined the terms of the proposed issue. Mr. Wendell, who obviously was already acquainted with the terms, stated that his society was interested in buying the entire issue direct from the Dixley Paper Company at the proposed price to the underwriters of $103 a share. The society's intention would be to hold the shares until they were redeemed in accordance with the proposed Retirement Provisions. Mr. Wendell added, however, that as a condition of purchase the society would require an agreement to register the issue in accordance with the provisions of the Securities Act of 1933 in the event that it chose to resell the stock.

Mr. Holmes replied that he would present Mr. Wendell's offer to the executive committee for consideration, although he doubted whether

[1] Cf. Dixley Paper Company (A), p. 130.

it would be received favorably. For one thing, he did not believe that management would like to see the entire issue in the hands of one owner. Such concentration of ownership, making possible a unanimity of action which was seldom obtained when an issue was distributed among a large number of stockholders, was a potential source of trouble. Furthermore, public distribution would enhance the marketability of any future issues that might be contemplated by making the company better known to the investing public. Mr. Holmes was also impressed by unfavorable reports that he had received from friends who had done business with insurance companies. According to these friends, he told Mr. Wendell, insurance companies required quarterly balance sheets and earnings statements and frequently sent their economists and statisticians to inquire into company affairs. In many instances, these insurance company representatives had caused considerable irritation.

Mr. Wendell conceded that there was truth in what Mr. Holmes said. Nevertheless, the society's proposal had a number of advantages which he thought ought to be considered. Among these were the following:

Closing of the transaction would take from two to three weeks as compared with two and a half or more months for a public issue, during which time the prospective underwriters could take advantage of changes in market conditions to ask for a revision of tentative terms or to withdraw altogether.

Except in the unlikely event that the society would at some future time exercise its right to have the securities registered, there would be no registration expense, which would normally amount to about $45,000, including underwriter's expenses to be borne by the company and cost of qualification under state blue-sky laws.

Management would be saved the trouble of preparing a registration statement, which took much executive time even when the greater part of the work was done by legal counsel. Moreover, much information about the company and its finances would have to appear in the prospectus, and detailed income statements, balance sheets, and surplus reconciliations would become available to the public and competitors. [Currently, only dividend notices and abbreviated balance sheets and income statements were published.]

Having a single stockholder would be of advantage in the event that management would ever desire the preferred stockholders to assent to or approve a corporate act. Negotiating with a great number of small stockholders, some of whom oftentimes proved to be troublemakers, could be a great burden to management.

Mr. Holmes listened to Mr. Wendell without comment, and then repeated his assurance that the offer would be presented to the executive committee and that Mr. Wendell would hear from him in the near future.

Continental Casualty Company (A)

The executives and directors of the Continental Casualty Company planned to obtain new capital by selling additional stock in the early spring of 1941. When the problem of pricing the issue arose, they faced the alternative whether to sell the stock through investment bankers for as high a price as possible or to give to the stockholders rights to buy shares at a lower price.[1]

Incorporated in Indiana in 1897, the Continental Casualty Company ranked fifth in volume of net premiums written during 1940 among American stock casualty companies. It was primarily concerned with writing three general types of insurance: accident and health, casualty, and bonding, the most important of which was casualty. The rest of the company's interests were absorbed in the investment and management of over $35,000,000 of assets not immediately tied up in the insurance operations of the business and in the affairs of various subsidiaries. For example, the company took an active part in the management of the Continental Assurance Company, by virtue of owning 36% of the latter's stock, which had about $280,000,000 of life insurance in force.

The company's insurance business was transacted through the home office in Chicago and seven branch offices located in large cities in the United States and Canada. Approximately 8,700 contract agents had varying degrees of authority to bind the company. About 25,000 brokers, while not having authority to bind the company, had placed business with it. The company also had a number of supervising general agents under contract and special agents under salary, who covered territory not assigned to branch offices. The authority granted to the respective contract agents of the company depended upon the type of risk to be

[1] In some states the "stockholders' pre-emptive right" to subscribe to new shares before nonshareholders may buy them is protected by the corporation law. In others (including Indiana) the right is not so protected.

insured and the agents' experience. The underwriting departments of the company at its home office supervised the business written by its agents and kept it within the bounds of the company's underwriting policy.

The actual and prospective growth of the company was the main reason for the decision of the directors to secure new funds. The volume of the business of the Continental Casualty Company was almost twice as great in 1940 as it had been in 1932. The period following 1935 had been one of particularly rapid growth for the company. For example, net premiums written increased from $16,019,986 in 1935 to $25,372,294 in 1940, and total admitted assets from $24,761,689 to $40,097,449.

The company had sold no capital stock since 1927. As is shown in Exhibit 1, however, the surplus of the company had been substantially increased through retention of a large percentage of annual income. Despite the increase in the capital through retention of earnings in the business, the management felt that a further increase in the capital accounts through the sale of common stock would put the company in a stronger financial position to carry the increasing liabilities that came with the larger volume of business. The addition of capital funds through the sale of stock, moreover, would make it possible for the company to pay out a larger percentage of future earnings in cash dividends. Because of the troubled international and political situation there was also some feeling among the directors that the market for common stock might become less favorable.

Accordingly, the directors voted on February 5, 1941, to sell 100,000 shares of $5.00 par common stock. At that time, all of the authorized shares of common stock, 400,000, were already outstanding. Therefore, a special meeting of the stockholders was called for March 10, at which time the stockholders would be asked to approve a change in the articles of incorporation of the company so as to authorize the issuance of the additional 100,000 shares of stock.

During 1940 the price of the company's stock, which was traded in the over-the-counter market, had ranged from a high of 38 bid (February 7, 1940) to a low of 27 bid (May 21, 1940). During January, 1941, the price range was from $34\frac{1}{4}$ (January 9) to 34 (January 22). In February the stock had ranged from $34\frac{3}{4}$ (on February 6) to $31\frac{1}{2}$ (on February 15 and 17). Since it was not expected that total earnings of the company would increase in proportion to the increase in the shares of common stock of the company, the new issue was expected to dilute earnings per share. The directors, nevertheless, thought that the new shares could be sold at prices close to the current market.

They planned to announce that it was their intention to pay about the same annual dividend per share as they had during the last three years, if the earnings of the company continued at substantially the level of those years. During 1939 and 1940 the company had paid a "regular" quarterly dividend of 30 cents a share and an "extra" dividend of 30 cents a share in the last quarter, making a total annual dividend of $1.50 a share. In 1938 the "extra" dividend in the last quarter was 40 cents a share, making at total annual dividend for that year of $1.60 a share. In 1939 a stock dividend of 50,000 shares (one for each seven outstanding) had been paid. In Exhibit 1, the record of the company's annual earnings and dividends for the previous 10 years shows the company's dividend policy and other financial data.

It was thought that an offering could be made successfully at approximately $32 a share. However, some directors suggested the desirability of giving to stockholders rights to buy the offering at $25. Under such a procedure, each stockholder would obtain transferable "rights" to purchase his pro rata share of the new issue. A letter to the stockholders, dated February 7, 1941, calling a meeting on March 10 to approve the issue of stock, was phrased in such manner as to permit the later adoption of either of the two plans.

Exhibit 1

CONTINENTAL CASUALTY COMPANY (A)

SELECTED DATA

(Dollar figures in thousands)

Year	*Underwriting Profit**	*Net Earnings from Investments*	*Operating Profit*	*Federal Taxes*	*Net Income*	*Cash Dividends*
1931	$ 351†[d]	$790	$ 439	†	$ 439	$560
1932	686†[d]	662	24[d]	†	24[d]	140
1933	673†[d]	615	58[d]	†	58[d]	. . .
1934	123†[d]	600	477	†	477	210
1935	121[d]	664	543	$ 50	493	210
1936	454	735	1,189	125	1,064	350
1937	1,049	736	1,785	160	1,625	525
1938	1,368	647	2,015	270	1,745	560
1939	885	829	1,714	265	1,449	585
1940	1,209	864	2,073	375	1,698	600

* Difference between income from insurance premiums and payments on policies plus expenses of the insurance phase of the business.
† After federal taxes. In 1935 and subsequent years underwriting results are before federal taxes.
[d] Deficit.

Continental Casualty Company (B)

In the spring of 1941 the directors of the Continental Casualty Company were considering whether to sell a proposed new issue of capital stock in the open market or to distribute it by issuing rights to be given to the existing stockholders.

After discussing the matter at some length, the directors voted to recommend a price of $25 and the use of rights to sell 100,000 shares. The decisive considerations leading to their recommendation were, first, that it would have a very beneficial effect on stockholder relationships, and, second, that the stockholders deserved consideration because of the conservative dividend policy followed in the past.

At a meeting on March 10, the stockholders voted in favor of the proposed issue and authorized the directors, at their discretion, to take the necessary steps to carry out the decision before February 4, 1942.

On March 24 the stockholders were informed that a registration statement and prospectus had been filed with the Securities and Exchange Commission. Although rights were to be used, it had been decided to underwrite the issue. The agreement with the underwriters, of whom the principal members were Glore, Forgan & Co. and Blair, Bonner & Company, is set forth in following excerpts from the prospectus:[1]

The underwriting agreement provides that in consideration of the agreements of the several underwriters the Company shall pay to each Underwriter on the closing date (*a*) a sum determined by multiplying $62,500 by the percentage share of each Underwriter in the underwriting (*b*) in addition, if the several Underwriters shall become obligated to purchase in the aggregate on the closing date more than 10,000 shares but not more than 25,000 shares of the Capital Stock, the sum of $1 for each share of the Capital Stock which such Underwriter shall purchase, or, if the several Underwriters shall become obligated to purchase

[1] Pp. 1, 20–21.

Exhibit 1

CONTINENTAL CASUALTY COMPANY (B)

CLOSING QUOTATIONS OF STOCK AND RIGHTS AT SELECTED DATES

(Over-the-Counter Market in Chicago)

	Stock, "Rights On"		Stock, "Ex-Rights"		Rights		Dow-Jones
	Bid	Asked	Bid	Asked	Bid	Asked	Industrials at Close
1940							
Feb. 7*	38	38½	...	...	...	...	146.63
May 21†	27	29	...	...	...	...	114.13
1941							
Jan. 9‡	35¼	35¾	...	...	...	...	133.39
22§	34	35	...	...	...	...	128.65
Feb. 5‡	34¾	35¼	...	...	...	...	124.14
6‡	34¾	35¼	...	...	...	...	124.76
11	32½	33	...	...	...	...	122.61
13‖§	31¾	32	...	...	...	...	121.10
17§	31½	32¼	...	...	...	...	119.18
Mar. 12§	31¾	32¼	...	...	...	...	123.19
29‡	33½	34	...	...	...	...	122.37
Apr. 1	33	33⅜	...	...	...	...	123.26
2	31¼	31¾	...	...	...	...	123.43
3	...	...	28	28¾	0.80	0.88	124.65
4	...	...	29	29½	1.00	1.10	124.64
5	...	...	28½	29¼	0.95	1.05	124.32
7	...	...	28½	29	0.85	0.92	123.65

Apr. 8	...	...	27	27½	0.50	0.60	121.21
9	...	...	26⅞	27⅜	0.40	0.50	119.85
10	...	...	28¼	29	0.70	...	119.66
11	...	...	28¼	29	0.50	...	¶
12	...	...	28¼	29¼	0.40	...	118.60
14	...	...	28¾	29¼	...	...	118.89
15	...	...	28½	29	...	...	118.59
16	...	...	28¼	28⅝	...	...	118.60
17	...	...	28⅜	28⅝	...	...	118.16
18	...	...	27¾	28¼	...	...	116.29
19	...	...	27¾	28½	...	...	116.15
21§	...	...	27½	28¼	...	...	116.06
30‡	...	...	29¼	29¾	...	...	115.54

* Year's high.
† Year's low.
‡ Month's high.
§ Month's low.
‖ Ex-dividend day: $0.30 per share.
¶ Good Friday, NYSE closed.

in the aggregate on the closing date more than 25,000 shares of the Capital Stock, the sum of $1.50 for each share of the Capital Stock which such Underwriter shall purchase.

The effect of this underwriting agreement was to assure the Continental Casualty Company of the sale of its issue, with proceeds to the company of at least $2,287,500, or $22.875 per share.

On April 2 subscription warrants or "rights" were mailed to stockholders of record at the close of business that day "evidencing the right to subscribe for Capital Stock of the Company at the rate of one-fourth ($\frac{1}{4}$) share for each share held." The warrants expired at 5:00 P.M. central standard time, April 12.

The record of the market of the stock from January through April, 1941, is shown in Exhibit 1. Before the expiration date the stockholders subscribed for 94,159 shares, leaving 5,841 shares which were bought by the underwriters at $25, according to the agreement. The underwriters received the minimum commission of $62,500 plus whatever profits they made by resale of the shares they purchased. These were sold at the market whenever the individual underwriters felt it desirable, but probably the bulk were sold at a profit of about $4.00 a share.

Johns-Manville Corporation[1]

The Johns-Manville Corporation announced on January 16, 1937, that it planned to issue 100,000 additional shares of common stock, without par value, and to make them available for subscription by holders of common stock in the ratio of one new share for each seven and one-half shares held. It was expected that the subscription price would be $100 a share, which would provide the company with $10,000,000, less expenses. This money would provide working capital for the company and its subsidiaries and enable them to enlarge manufacturing and operating facilities.

In the prospectus it was estimated that net proceeds of the issue would amount to $9,651,320 after deducting estimated expenses of $198,680 and underwriting discounts. Although the net proceeds were not allocated to any specific uses, the corporation contemplated that approximately $3,420,000 would be expended after January 1, 1937, for manufacturing, mining, and operating facilities; $1,300,000 would be used to increase the capital of Johns-Manville Credit Corporation, a subsidiary engaged in providing installment credit to dealers and contractors in connection with the sale of the corporation's products; and $5,000,000 would be used as working capital, of which about $3,500,000 would reimburse the treasury for expenditures for mining, manufacturing, and operating facilities made during 1936.

The company had outstanding 75,000 shares of $100 par cumulative 7% preferred stock, of an authorized issue of 100,000 shares, and 750,000 shares of no-par common stock, of an authorized issue of 1,000,000 shares. The proposed issue was to be part of the 250,000 shares authorized but not issued. Balance sheets and a few financial statistics of the corporation are shown in Exhibits 1 and 2. Prices of the common stock are given in Exhibits 2 and 3.

[1] The material in this case is from various published sources.

In conformance with this plan the corporation filed a registration statement with the Securities and Exchange Commission and, when this registration became effective, offered to its common stockholders of record, at the close of business on February 19, 1937, pro rata rights to subscribe in the aggregate to 100,000 shares of additional common. Each such holder was offered, until 3:00 P.M. on March 11, 1937, the right to subscribe to two-fifteenths of one share at $100 a share for each share held. Transferable subscription warrants evidencing such rights were to be mailed to stockholders as soon as practicable after February 19, 1937. Stock certificates were to be deliverable at the office of J. P. Morgan & Co., 23 Wall Street, New York, after the exercise of the warrants.

The offering to stockholders was underwritten by eight investment houses, of which each had a 10% interest in the purchase of unsubscribed stock except Morgan Stanley & Co., Incorporated, which had 30%. These underwriters severally agreed to purchase, at $100 a share, according to the foregoing percentages, such of the 100,000 shares as were not subscribed for by the holders of subscription warrants. For this underwriting, the corporation was to pay the underwriters $150,000. The underwriting contract also provided that, if any underwriter should fail or refuse to purchase the percentage of unsubscribed stock which it was required under the contract to purchase, Morgan Stanley & Co., Incorporated, would purchase for its own account or find purchasers for such percentage of unsubscribed stock.

There appeared in the *Wall Street Journal* for March 29, 1937, an account of the corporation's annual meeting which read, in part, as follows:

> Business of the Johns-Manville Corp. so far this year has been showing a substantial increase over the like 1936 period, President Lewis H. Brown told stockholders at their annual meeting Friday. . . . The increase in sales in the initial quarter of 1937, he added, was not due to stocking up by dealers, although advance buying by the trade was somewhat better than a year ago. . . .

Commenting on 1936 business, Mr. Brown said that sales increased progressively as the year advanced, with a sharp acceleration being experienced in the final months. He said that the price war in the asphalt materials field, which adversely affected Johns-Manville's showing in the initial quarter, terminated more quickly than had been anticipated. . . . For the entire year, sales totaled $48,922,011, yielding a net profit of $4,373,707, equivalent after preferred dividends to $5.13 a share on the then outstanding 750,000 shares of common stock.

All but 650 shares of the recent issue of 100,000 shares of Johns-Manville common stock were subscribed for by stockholders at $100 a share, Mr. Brown stated, in answer to a question by Col. B. F. Castle of the Administrative & Research Corporation, a stockholder. After stating that he did not see any set of circumstances that necessitated the expenses entailed in the underwriting of the issue, Col. Castle asked if Mr. Brown did not think the strong position of the company would have enabled it to have dispensed with that service. In reply Mr. Brown said that the underwriting was agreed upon only after lengthy consideration of the many factors involved. These, he said, included the troubled labor conditions in this country and the threat of a European war due to acuteness of the Spanish situation at that time. Also, it was one of the first sales of a large issue of new stock by a major corporation since the depression. In view of all this and the relative moderateness of the fee ($1\frac{1}{2}\%$) in comparison to the amount involved, Mr. Brown said, "I made the decision and it was my best judgment and I am very well satisfied with the whole picture."

Exhibit 1

JOHNS-MANVILLE CORPORATION

CONDENSED COMPARATIVE CONSOLIDATED BALANCE SHEETS

(Dollar figures in thousands)

ASSETS

	Dec. 31 1935*	Oct. 31 1936†	Dec. 31 1936*
Cash	$ 4,061	$ 4,092	$ 3,149
Notes and accounts receivable, net	3,692	6,565	5,662
Inventories	5,957	7,032	7,495
	$13,710	$17,689	$16,305
Land, buildings, equipment, mineral properties, etc., net	21,218	22,094	22,565
Investment and advances to J-M Credit Corp.	2,400	1,300	1,200
Miscellaneous	980	687	614
	$38,308	$41,770	$40,684

LIABILITIES

	Dec. 31 1935*	Oct. 31 1936†	Dec. 31 1936*
Accounts payable	$ 1,115	$ 1,883	$ 1,817
Accrued liabilities	551	1,463	933
Reserve for income taxes	541	1,027	1,131
Other current	506	100	131
	$ 2,712	$ 4,473	$ 4,013
Reserves	723	743	758
Minority interest in subsidiaries	60	67	64
Preferred Stock, at liquidation value	9,000	9,000	9,000
Common stock	15,000	15,000	15,000
Initial surplus‡	6,683	6,683	6,683
Earned surplus	4,131	5,804	5,167
	$38,308	$41,770	$40,684

* Source: Poor's *Industrials*, 1937.
† Source: Prospectus of February 15, 1937.
‡ After deducting $1,500 transferred to capital account in order to carry preferred stock at liquidation value.

Exhibit 2

JOHNS-MANVILLE CORPORATION

SELECTED STATISTICS*

(Dollar figures in thousands)

Years	Common Stock Prices High	Common Stock Prices Low	Sales	Net Earnings	Dividends Preferred	Dividends Common	Net Worth
1927	126½	55½	$44,313	$4,108	$525	$2,250	$32,016
1928	202	96¼	47,910	5,589	525	2,250	34,830
1929	242¾	90	61,994	6,591	525	2,250	38,647
1930	148⅜	48¾	49,492	3,268	525	2,250	39,140
1931	80¾	15⅝	33,481	583	525	1,875	37,324
1932	33⅜	10	20,409	2,680[d]	525	....	34,118
1933	63½	12¼	21,232	105	393	....	33,830
1934	66⅜	39	27,300	749	656	....	33,923
1935	99½	38½	34,646	2,164	525	750	34,813
1936	152	88	48,922	4,373	525	2,812	35,849

* Source: *J-M Stockholders' News*, January, 1938; except for stock prices, which were taken from the Prospectus of February 15, 1937.
[d] Deficit.

Exhibit 3

JOHNS-MANVILLE CORPORATION

COMMON STOCK AND SUBSCRIPTION WARRANT PRICES

	Common Stock		Subscription Warrants	
Weeks Ending	High	Low	High	Low
Dec. 4, 1936	144	139	..	..
11	$143\frac{1}{2}$	141	..	..
18	$146\frac{1}{2}$	$143\frac{1}{2}$	..	..
25	145	$141\frac{1}{2}$	..	..
Jan. 1, 1937	$146\frac{1}{4}$	145	..	..
8	155	$148\frac{1}{2}$	..	..
15	155	153	..	..
22	$154\frac{1}{2}$	143	..	..
29	150	143	..	..
Feb. 5, 1937	$147\frac{3}{4}$	$144\frac{1}{2}$	..	..
12	$147\frac{3}{4}$	$144\frac{1}{2}$	..	..
19	150	$146\frac{1}{2}$	..	..
Ex-Rights				
Feb. 19, 1937	139	$136\frac{1}{2}$	..	..
26	$138\frac{1}{2}$	$134\frac{1}{8}$	$5\frac{1}{16}$	$4\frac{3}{8}$
Mar. 5, 1937	$145\frac{1}{2}$	134	$5\frac{15}{16}$	$4\frac{5}{16}$
12	$148\frac{1}{2}$	140	$6\frac{3}{8}$	$5\frac{1}{4}$
20	147	141	..	..
27	$144\frac{1}{2}$	$138\frac{1}{4}$	..	..

Pure Oil Company[1]

On February 13, 1937, the directors of the Pure Oil Company, an Ohio corporation, decided that current conditions in the securities markets were favorable to the sale by the company of a large issue of preferred stock. It was planned to issue some 420,000 shares of $100 par preferred stock. The company currently had outstanding large issues of 8% and 6% cumulative preferred stock, and the proposed issue would rank equally with the 8% and 6% issues as regards preference in dividends and assets.

According to company officials, the proceeds of the proposed issue of new preferred stock would be used for four major purposes. The first was the retirement of the outstanding $7,662,000 of 8% preferred stock, which was callable at $110 a share plus accrued dividends on any dividend date provided 60 days' advance notice was given.

The second major use for the new money was the retirement of an outstanding issue of $4\frac{1}{4}$% notes. These notes had been sold to the public in 1935 through an underwriting syndicate of investment bankers headed by Edward B. Smith & Company. Nondetachable warrents on each $1,000 note entitled the holder to purchase 30 shares of common stock, currently selling at a price of $15 a share. Through the use of funds obtained by the exercise of common stock purchase warrants attached to the notes, the original issue of $32,000,000 had been reduced to $28,500,000 in February, 1937, and on February 10, 1937, $1,211,300 in cash was available for further retirement of these notes. The notes could be called on any interest date (January 1 and July 1), provided 30 days' notice was given.

It was also expected that some $4,000,000 of bank debt currently outstanding would be retired. Finally, the company desired to develop further its oil producing and refining properties.

[1] The material in this case is from various published sources.

At a special meeting held on March 26, 1937, the stockholders of the company voted to amend the articles of incorporation so as to authorize the new issue of preferred stock. In addition, the number of authorized common shares was increased from 4,000,000 to 10,000,000 shares.

On May 3, 1937, the company filed a registration statement with the Securities and Exchange Commission covering 469,454 shares of cumulative convertible preferred stock. It was planned that the new preferred stock would be convertible into common shares and would be offered first to the common stockholders of the company as of May 28, 1937. The new preferred would be offered at par ($100), and subscription rights would be good until June 18, 1937. The dividend rate on the new issue, as well as the rates at which the preferred stock could be converted into common stock, had not been announced. They were to be supplied later by amendment to the registration statement. It was expected that Edward B. Smith & Company would form a syndicate of investment bankers to purchase any shares not subscribed to by the common stockholders.

In the meantime, in order that the company could safely announce the call on July 1 of the $4\frac{1}{4}\%$ notes, the company on March 13 entered into a stand-by loan agreement with six large commercial banks. In effect, the banks agreed, if called upon, to loan the company as much as $25,000,000 on June 29, 1937, the money to be used to redeem the $4\frac{1}{4}\%$ notes. Under the agreement the bank loans would be repaid out of the proceeds of the sale of the new convertible preferred when and if such sale were accomplished. In any case, the bank loans were to be repaid within three years. In return for the commitment to loan if necessary, the banks were paid $125,000 by the Pure Oil Company.

In June, 1937, the company filed an amendment to the registration statement postponing the offering date of the new preferred stock to June 25, 1937. However, before June 25, the offering was again postponed. On June 28, 1937, an official of the company stated: "The proposed financing which we have in contemplation has been delayed due to market conditions in this country. We are hopeful that the delay is only a temporary one." Prices for the principal Pure Oil securities as well as the Dow-Jones average of market prices of selected common stocks of industrial companies are given in tabular form in Exhibit 2 and graphically in Chart 1 (p. 200).

On August 23, 1937, the president of the Pure Oil Company in a letter to common stockholders announced that the company would pro-

ceed with the offering of preferred stock. He stated that the directors had authorized the offering to common shareholders of record on September 3, 1937, of the right to subscribe to 5% cumulative convertible preferred stock at $100 per share. For every nine shares of common stock held, the common stockholder would receive rights to purchase one share of the new convertible preferred stock. The rights to subscribe to the preferred stock would expire on September 24, 1937.

The initial conversion price on the new preferred was set by the board of directors at 22.22\frac{2}{9}$. In other words, at any time up to October 1, 1940, each preferred share could be converted into 4$\frac{1}{2}$ shares of common stock. After October 1, 1940, the rate of conversion changed to 4 for 1, and after October 1, 1942, to 3$\frac{1}{3}$ for 1. The conversion privilege expired October, 1947.

The stock purchase rights were transferable and arrangements were made to admit the rights to trading on the New York Stock Exchange.

Underwriting of the issue was provided by a syndicate of 42 investment banking houses headed by Edward B. Smith & Company; the latter house alone took 13$\frac{1}{2}$% of the commitment. In return for the underwriter's agreement to purchase all the preferred shares not taken up by the common stockholders, they received an underwriting fee of $2.50 per share, or a total of $1,106,107.50 on the maximum of 442,443 preferred shares offered.

On September 27, the company announced that stockholders had subscribed to 8,040 shares of the preferred stock. Thus 434,394 shares with a par value of $43,439,400 were left for purchase by the underwriters. On October 22, 1937, the 42 investment banking firms took, and paid the company for, the unsubscribed preferred shares. Thereupon, the company called its outstanding 8% preferred shares for redemption on January 1, 1938; all of the company's bank loans were also paid off. Pure Oil's balance sheets as of April 30 and December 31, 1937, are shown in Exhibit 1.

In the currently depressed and unsettled market (see Exhibit 2) the underwriters decided not to offer the unsubscribed shares for public sale.[2] Through joint agreement the underwriter's shares were thus held off the market until after March 9, 1938, when the agreement among the underwriters as to joint action in the sale of the securities terminated

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[2] Their failure to make the shares available to the public resulted in the inability of short sellers of the stock to acquire stock for delivery against their open contracts. After considerable investigation and negotiation, the Committee on Securities of the New York Stock Exchange announced that Edward B. Smith & Co. would make up to 5,000 shares of the stock available at $100 a share flat on and after December 6 but not beyond December 9, 1937. It had been disclosed that members of the New York Stock Exchange had open contracts to buy 10,116 shares and to sell 9,339 shares.

Exhibit 1

THE PURE OIL COMPANY

CONDENSED COMPARATIVE CONSOLIDATED BALANCE SHEETS

(Dollar figures in thousands)

		April 30, 1937	*December 31, 1937*
ASSETS			
Cash, etc.		$ 5,152	$ 10,460
Receivables, net		8,430	8,625
Inventories		23,016	21,417
Due from subsidiary not consolidated		198	215
		$ 36,797	$ 40,716
Investments, advances, etc.		9,690	10,468
Plant, net		98,018	106,908
Contracts, patents, etc.		19,694	19,694
Prepaid and deferred charges		1,889	656
		$166,088	$178,442
LIABILITIES			
Bank loans of subsidiaries	$ 707		$ 335
Current bank loan maturities	1,000	$ 1,707	......
Purchase obligations		2,302	2,920
Accounts payable		8,567	8,517
Dividends payable		......	970
Accruals		2,167	1,690
		$ 14,743	$ 14,431
15-year notes outstanding	$28,500		
Less: Redemption cash	4,339	24,161	......
Bank loans due 1938–1940		3,000	......
Deferred purchase obligations		2,965	2,666
Minority interests in subsidiaries		3,768	3,354
Preferred stock		35,962	72,118
Common stock		35,740	39,820
Surplus		45,748	46,053
		$166,088	$178,442

Exhibit 2

PURE OIL COMPANY

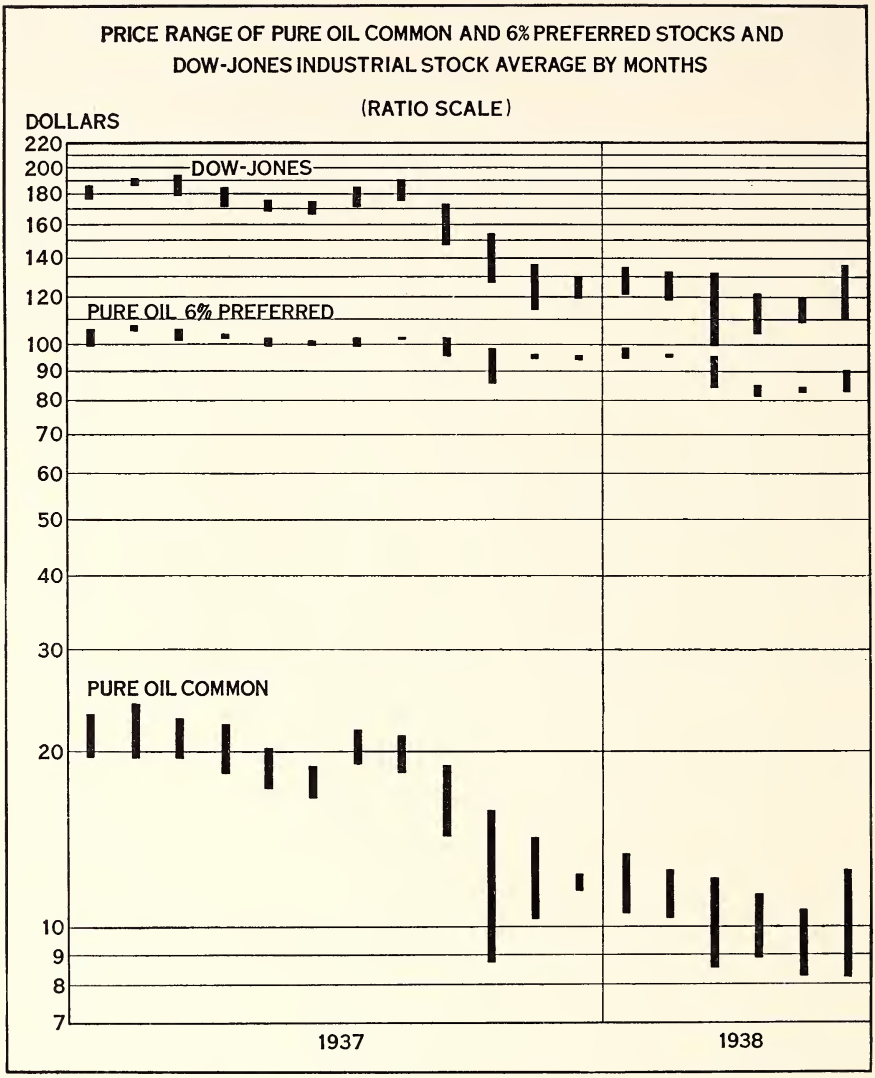
SELECTED DATA

Date	Net Income (in Thousands of Dollars)	Income per Share of Common Stock after Allowance for Preferred Dividends*	Common Stock Prices on New York Stock Exchange† High	Common Stock Prices on New York Stock Exchange† Low	6% Preferred Stock Prices on New York Stock Exchange High	6% Preferred Stock Prices on New York Stock Exchange Low	Dow-Jones Averages Industrial Common Stocks High	Dow-Jones Averages Industrial Common Stocks Low
1928	$ 4,837	$0.97	$31\frac{1}{4}$	19	103	98	300	191.33
1929	11,224	3.06	$30\frac{3}{4}$	20	$103\frac{3}{4}$	96	381.17	198.69
1930	6,540	1.52	$27\frac{1}{4}$	$7\frac{5}{8}$	99	$81\frac{3}{4}$	294.07	157.51
1931	2,618	0.18	$11\frac{7}{8}$	$3\frac{1}{4}$	$83\frac{1}{2}$	$49\frac{7}{8}$	194.36	73.79
1932	642	0.47^{d}	$6\frac{1}{2}$	$2\frac{7}{8}$	$60\frac{3}{4}$	40	88.78	41.22
1933	811	0.41^{d}	$15\frac{3}{8}$	$2\frac{1}{2}$	$56\frac{3}{4}$	20	108.67	50.16
1934	885^{d}	0.97^{d}	$14\frac{7}{8}$	$6\frac{1}{8}$	63	$33\frac{1}{2}$	110.74	85.51
1935	8,150	2.00	17	$5\frac{7}{8}$	103	$34\frac{3}{4}$	148.44	96.71
1936	7,658	1.63	$24\frac{7}{8}$	16	118	$91\frac{1}{4}$	184.90	143.11
1937								
Jan.	....	...	$23\frac{1}{4}$	$19\frac{3}{4}$	$105\frac{3}{4}$	99	186.90	177.72
Feb.	....	...	$24\frac{3}{8}$	$19\frac{1}{2}$	107	105	190.29	186.01
Mar.	....	...	$22\frac{7}{8}$	$19\frac{1}{2}$	106	101	194.40	179.82
Apr.	....	...	$22\frac{1}{4}$	$18\frac{1}{4}$	$103\frac{3}{4}$	102	185.19	170.13

1937								
May	....	...	$20\frac{3}{8}$	$17\frac{1}{4}$	102	99	176.30	167.46
May 3	....	...	$20\frac{1}{8}$	$19\frac{1}{2}$	$102\frac{1}{2}$	101	...	...
June	....	...	$18\frac{3}{4}$	$16\frac{5}{8}$	101	$99\frac{1}{2}$	175.14	165.51
June 28	....	...	$17\frac{3}{4}$	17	101	99	...	...
July	....	...	$21\frac{3}{4}$	19	102	99	185.61	170.13
Aug.	....	...	$21\frac{3}{8}$	$18\frac{1}{2}$	102	101	190.02	175.91
Aug. 23	....	...	$20\frac{1}{4}$	$19\frac{3}{8}$	103	101	...	...
Sept.	....	...	$18\frac{7}{8}$	$14\frac{1}{4}$	$101\frac{1}{2}$	95	173.08	147.38
Sept. 3	....	...	$18\frac{3}{8}$	$17\frac{7}{8}$	102	$101\frac{1}{2}$	...	...
Sept. 23	....	...	16	$15\frac{1}{4}$	$97\frac{1}{2}$	96	...	...
Oct.	....	...	$15\frac{7}{8}$	$8\frac{3}{4}$	$97\frac{3}{4}$	85	154.08	125.73
Nov.	....	...	$14\frac{1}{4}$	$10\frac{1}{4}$	$86\frac{1}{2}$	94	135.94	113.64
Dec.	....	...	$12\frac{3}{8}$	$11\frac{1}{2}$	$95\frac{1}{4}$	$93\frac{1}{2}$	129.98	118.93
1938								
Jan.	....	...	$13\frac{3}{8}$	$10\frac{1}{2}$	$98\frac{1}{4}$	94	134.35	120.14
Feb.	....	...	$12\frac{1}{2}$	$10\frac{1}{4}$	96	$94\frac{3}{4}$	132.41	118.49
Mar.	....	...	$12\frac{1}{8}$	$8\frac{1}{2}$	$95\frac{1}{2}$	$83\frac{7}{8}$	130.47	98.95
Apr.	....	...	$11\frac{3}{8}$	$8\frac{7}{8}$	85	81	121.00	103.02
May	....	...	$10\frac{3}{4}$	$8\frac{1}{4}$	$84\frac{1}{2}$	82	119.43	107.74
June	....	...	$12\frac{1}{2}$	$8\frac{1}{4}$	90	$82\frac{1}{2}$	135.87	109.71

* No common dividends were paid from 1931 through 1937.
† Stock purchase rights were traded in during September, 1937, at prices ranging from $\frac{3}{16}$ to $\frac{1}{32}$.
[d] Deficit.

Chart 1



and each underwriting firm was free to dispose of its shares in such manner and at such prices as it might see fit. No agreement was made among the underwriters for a public offering; each was to buy, sell, or hold the shares at its own discretion.[3]

[3] The Securities and Exchange Commission set a precedent in the supervision and regulation of trading in this instance by requiring full reports on the positions and transactions of the Pure Oil underwriters beginning March 10 and by ordering them to make no purchases of the stock at a price above 74½, although the prices at which they might sell were not restricted.

Northern Indiana Public Service Company

Central Maine Power Company

[Editor's Note.—The following material consists of excerpts from two decisions of the Securities and Exchange Commission interpreting Rule U-50 under the Public Utility Holding Company Act of 1935. Briefly, this rule requires that companies under the jurisdiction of this law shall normally arrange for competitive bidding as a part of the procedure of issuing securities.

The decisions selected emphasize matters connected with established relationships between investment bankers and issuers of securities.]

NORTHERN INDIANA PUBLIC SERVICE COMPANY
Decided May 5, 1944

Northern Indiana Public Service Company ("Northern Indiana") has filed applications and declarations with respect to proposed transactions including, among other things, the issuance and sale of 220,078 shares of new cumulative 5% dividend preferred stock, $100 par value, under the Public Utility Holding Company Act of 1935. Its application in this connection is filed under Section 6 (b) of the Act. Northern Indiana requests that the issue and sale be excepted from the competitive bidding requirements of Rule U-50.

The sole problem with which we are concerned here is the requested exception of the proposed issue and sale from competitive bidding. A hearing was held after appropriate notice, a brief was filed by Northern Indiana on this question, and we heard oral argument thereon. . . .

. . . The company proposes to call its existing preferred shares at their respective call prices and to issue an identical number of new preferred shares, $100 par value, with a 5% cumulative dividend, offering them first in exchange for the old shares and selling the balance to underwriters for public distribution. . . .

Northern Indiana believes it would be to the best interests of itself and its security holders to exchange as many of the new shares as pos-

sible for old shares in the hands of existing holders, paying in cash the differential between the offering price of the new shares and the call price of the old. It believes that existing stockholders would be benefited tax-wise by such exchanges and estimates that the compensation it must pay to investment bankers for soliciting such exchanges would be less than the cost of selling the entire issue to the general public. These are among the reasons for its plan to make the offering initially to its existing preferred stockholders, employing investment bankers to solicit exchanges and to underwrite the unexchanged portion of the new issue.

The company proposes to compensate the bankers on a sliding scale for exchange solicitation, contending that by this method savings resulting from exchanges (as distinguished from cash sales) will be likely to accrue to it rather than to the underwriters. It has entered into a tentative arrangement whereby Stone & Webster and Blodget, Inc., and Harriman, Ripley & Co., Inc., would lead a large group of bankers which would be paid for soliciting exchanges, standing by during the exchange period, and purchasing for public distribution all shares not taken by existing stockholders in exchange for old shares.

. . . .

Under the proposed arrangement the bankers would receive compensation equal to (*a*) \$1.00 as a stand-by charge for each of the 220,078 new shares; plus (*b*) an amount varying from 50¢ for each share exchanged (if not more than 110,000 shares) to 75¢ for each share exchanged (if more than 198,000 shares); plus (*c*) an amount varying from \$1.50 per share purchased by the underwriting group (if the aggregate number purchased is less than 22,000 shares) to \$2.50 per share purchased (if such aggregate is 110,000 shares or more).

Thus, the minimum compensation, if all shares were exchanged, would be \$1.75 per share, or a total of \$385,136; and the maximum, if no shares were exchanged, would be \$3.50 per share, or a total of \$770,273. Northern Indiana estimates that about 80% of the new shares will be issued in exchange for the old. On this basis payments to the bankers would be slightly over \$420,000, or \$1.90 per share.

As heretofore stated, the company requests an exception from the provisions of Rule U-50 requiring competitive bidding as a condition to the proposed security issue. We believe the request must be denied.

We should make it clear first that we do not take issue with the company's view as to the desirability of the refinancing or with the

method of exchange as the means of achieving it. Nor do we necessarily disapprove the principle of compensating underwriters on a sliding scale.

However, the grounds for the company's preference for private negotiation do not appear to us to be sufficiently persuasive to justify the granting of an exception; and the method through which the underwriters were selected and their compensation arrived at, and by which the public offering price is to be set, is subject to objections of a kind that formed a substantial part of the basis for our adoption of the competitive bidding rule.

As we have noted, Northern Indiana regards a large volume of exchanges as desirable because the financing is expected to be cheaper by that method. It also desires to retain as many of the present preferred stockholders as possible. It regards the sliding scale of compensation as an incentive to the underwriters to procure as many exchanges as possible in preference to direct sales and as a method of retaining for itself a portion of the savings in financing costs which would result from a large volume of exchanges.

Assuming a sliding scale of compensation, varying with the number of exchanges accomplished, the company contends that competitive bidding is not feasible since bids might vary at the several levels in the scale, one bid being more favorable for a certain number of exchanges, a second bid for a different number of exchanges, a third for still another number of exchanges, and so on. This, the company asserts, would render it impossible to pick the best bid.

As an alternative, our staff advanced the tentative suggestion that bids be solicited specifying (*a*) the public offering price for the new 5% preferred and (*b*) a lump sum to compensate the underwriters for the over-all job of soliciting exchanges, standing by, and underwriting shares not exchanged. This suggestion contemplated that the underwriters would be permitted to begin selling the stock during the exchange period subject to the stockholders' prior right of exchange.

. . . .

While some of the grounds offered by the company may possess a certain validity, they are not, in our opinion, sufficiently cogent to justify concluding the matter in favor of an exception from the rule. In the first place it is by no means certain that compensation on a sliding scale offers the expected inducement to underwriters to effect exchanges in preference to sales; nor is it necessarily true that, if bids were made competi-

tively on a sliding scale, differences in the bids at varying levels of the volume of stock exchanged would be such as to preclude the selection of the best bid from among them. It is entirely possible that one bid may be superior to the rest in all levels, or at least for the volume of exchanges that the company considers within the range of probability. The selection of the best bid by the company need not be a purely mechanical matter. The company has its own estimate of the probable volume of exchanges. Dean H. Mitchell, the company's president, testified that he thought at least 80% of the outstanding shares would be exchanged for the new stock. Even with bids on a sliding scale the company would be well within its rights in attaching weight to the bid that seemed most favorable to it at the level of exchanges which it anticipates, and discarding other bids even though they appeared more favorable at other levels.

The remainder of the company's arguments—that the compensation is fair and reasonable, that the price for the unexchanged shares is expected to be adequate, that the officers have exercised their best business judgment, and that experts have been consulted—are not peculiar to the situation presented by this exchange program. They are the familiar arguments advanced in opposition to the general principle of competitive bidding embodied in Rule U-50. In adopting the rule we pointed out that bids on a competitive basis are in general likely to be of substantial aid in determining whether or not the price and other terms of the issue are fair and reasonable, and our adoption of the rule was in part for the very purpose of affording assistance in the determination of such questions. The company's contentions in this respect cannot, therefore, serve as a basis for an exception from the rule in the absence of extraordinary circumstances.

. . . .

We turn now to an examination of the negotiations [as conducted].

The exchange program coupled with a stand-by underwriting agreement has, according to Mitchell's testimony, been contemplated for several years, during which discussions were held at intervals with Harriman, Ripley & Co., Inc., and with Stone & Webster and Blodget, Inc. During the summer of 1943 discussions with Harriman, Ripley & Co. were resumed and the transaction was given considerable study, but certain provisions of the tax law, since amended, made it inadvisable to refinance at the time. In October, 1943, Stone & Webster and Blodget

expressed an interest in formulating a refinancing plan, but still no definite proposal was evolved.

Early in 1944 the company became convinced that from a market viewpoint it was feasible to proceed with the transaction, and active discussions were again held with both financial houses. On February 2, 1944, Harriman, Ripley & Co. furnished the company with a tentative schedule of fees for the refinancing program. Despite the fact that this schedule was only tentative and that no schedule at all had been submitted by Stone & Webster and Blodget, the company early in March, 1944, orally advised the two houses that they would be jointly engaged as exchange solicitors and underwriters, with 75% of the issue going to Stone & Webster and Blodget and 25% to Harriman, Ripley & Co.

On April 5, 1944, the present application-declaration was filed. On April 13, 1944, a conference was held between the company and Harriman, Ripley & Co., Inc., and Stone & Webster and Blodget, Inc. This was the first meeting of the company with the two houses since it informed them that they were jointly awarded the refinancing. At this conference, Harriman, Ripley & Co. withdrew the tentative schedule of fees it had submitted on February 2, 1944, asserting that market conditions for preferred stocks had changed, and the two underwriting firms then submitted a new schedule of fees covering their compensation. The schedule had been arrived at without the participation of the company and was somewhat higher than the prior tentative offer submitted by Harriman, Ripley & Co. It was approved by the company and is embodied in the filing before us. Up to April 28, 1944, when oral argument was held before us, the price the underwriters would offer for the unexchanged shares and the length of time for the exchange offer, were undetermined.

An oral understanding exists between the company and Harriman, Ripley & Co. and Stone & Webster and Blodget that, if the present application for an exception from Rule U-50 is denied and the issue is held subject to competitive bidding, the two firms will be paid for services already rendered and expenses incurred in an amount not to exceed $20,000.

An exhibit introduced in the record contains a tentative list of 70 underwriters assembled by Stone & Webster and Blodget and Harriman, Ripley & Co. With few exceptions, practically every underwriting house of importance is included in the list.

It thus appears that the company made its selection of underwriters without definite knowledge of the terms they would offer. It appears further that the possibility of submitting the refinancing to competitive bidding was summarily dismissed by the company. Mitchell testified that he did not know how competitive bidding could be effected with an exchange offer and that both of the designated underwriting houses told him, in response to his question on the subject, that competitive bidding was not feasible. Our staff is available for consultation on financing proposals and for the expression of its opinion on the appropriateness of applying for an exemption from competitive bidding in a security flotation. Its views were not sought. The decision to request the exemption was that of the company alone, and the only outside advice it had was not disinterested.

We may note that in 1942 we rejected a similar request by the Public Service Company of Indiana, which, like the applicant, is a company in the Midland United system, with respect to a proposed issue of bonds under circumstances of which the present application is reminiscent. In *Public Service Company of Indiana* we said:

"Our competitive bidding rule applies, and was intended to apply to all such securities and to preferred and common stocks as well. Indeed, there is usually more reason for resorting to competitive bidding in the case of securities below the high grade bond level because it is normally more difficult to ascertain a fair and adequate price for them. The range of fluctuation is greater for such securities. Competitive bidding—with all prospective purchasers given an opportunity to buy the proposed securities—insures that the most equitable price will be obtained.

"We must also reject the suggestion that an exception from our competitive bidding requirements should be granted because there is a possibility that bidding may result in a lower price than can be obtained under the present commitment. True, such a possibility exists but there is, at the least, an equal possibility that the bonds may be sold at higher prices through competitive bidding. If such an argument were permitted to be persuasive, the competitive bidding rule could be completely nullified in every case where, notwithstanding our Rule, a company enters into a private contract for the sale of securities and, thereafter, petitions for an exception to the Rule. Furthermore, this argument ignores the fact that our competitive bidding rule is also designed to assure the

maintenance of competitive conditions and to eliminate any possibility that affiliated underwriters or other purchasers will monopolize the distribution or purchase of securities or will obtain them on more favorable terms than others. . . .

"In promulgating the Rule, we obviously did not intend that exceptions from it would be lightly granted; an issuer, therefore, cannot act on the assumption that no attempt need be made to comply with its general requirements. . . . It appears to us that the company unwarrantably assumed that it could disregard the competitive bidding rule and make such full arrangements for the private sale of its securities that the Commission would be compelled to grant its application for an exception or else face the onus of delaying the issue. We cannot permit ourselves to be jockeyed into such a position. . . ."

An appropriate order will issue denying the request for exception from Rule U-50.

By the Commission (Commissioners Healy, Pike, and McConnaughey), Chairman Purcell not participating, and Commissioner O'Brien filing a dissenting opinion.

CENTRAL MAINE POWER COMPANY

Decided February 2, 1949

Central Maine Power Company ("Central Maine"), a Maine corporation, has filed an amended application pursuant to Section 6 (b) of the Public Utility Holding Company Act of 1935 and Rule U-50 thereunder with respect to a proposed issue and sale of 286,496 shares of its common stock. . . . The application requests that the proposed transaction be exempted from the provisions of Sections 6 (a) and 7 of the Act and from the competitive bidding requirements of Rule U-50.

After appropriate notice a public hearing was held. We have considered the record and upon the basis thereof make the following findings:

Central Maine proposes to issue and sell for cash up to 286,496 shares of its common stock, $10 par value, the net proceeds to be applied to the reduction of the company's short-term bank loans made in connection with its current construction program.

The common stockholders and the 6% preferred stockholders of the company have pre-emptive rights to subscribe to the new common stock. NEPSCO, owner of 77.8% of the common stock of Central

Maine, has advised the company that it will waive its pre-emptive rights in the new issue, amounting to 219,196 shares of the new common stock. The company proposes to offer the remaining 67,300 shares to its other common stockholders and to its 6% preferred stockholders for subscription, pursuant to their pre-emptive rights, as follows: One-sixth of a share of common stock for each share of common stock presently held and five-sixths of a share of common stock for each share of 6% preferred stock. Negotiable subscription warrants will be issued evidencing such rights. Fractional shares of stock will not be issued. The subscription period will be from 10 to 15 days.

The company proposes to sell the entire issue, subject to pre-emptive rights, to an underwriter. By reason of NEPSCO's waiver of its pre-emptive rights with respect to 219,196 shares of the proposed issue, the underwriter will be in a position to offer such shares for sale to the public without waiting for the expiration of the subscription period. It is proposed that the price at which the stock is offered for subscription by stockholders will be the same as the price to the public. The company proposes to select an underwriter after negotiations with three or more investment bankers and in this connection requests an exemption from the competitive bidding requirements of Rule U-50.

. . . .

In support of its application for exemption from the competitive bidding requirements of Rule U-50, Central Maine cities, among other things, its unsuccessful attempt to sell common stock at competitive bidding in December, 1947. At that time the stock was quoted at $17 a share and it was understood that a number of groups were planning to bid. However, only one bid was received, at a price to the company of $12 a share. This bid was rejected by the company. It appears that one of the reasons for the lack of underwriter interest at that time was the fact that the company was experiencing severe drought conditions. These conditions substantially reduced the amount of energy generated in the company's hydroelectric plants and accordingly increased its operating costs. The company claims that since that time its earnings record has not clarified sufficiently to warrant an offer at competitive bidding, in the light of its prior experience in December, 1947. The drought experienced in the last five months of 1947 continued throughout the first three months of 1948, and another period of drought was experienced from the end of June until early October, 1948. While, beginning in July, 1948, the company obtained rate increases estimated on the basis

of 1947 sales to produce approximately $1,500,000 of revenues annually, and while it appears that water conditions in the last quarter of 1948 have been substantially normal, the company emphasizes that such favorable factors are only partially reflected in its income statement for the year ended December 31, 1948, which necessarily reflects the adverse condition prevailing for the first half of the year.

On the basis of the unsuccessful bid and the attendant circumstances, we feel that the company has made out a case for exemption from competitive bidding. However, the company's relationships and its activities, prior to the filing of the instant amended application, with the investment banking firm of Coffin & Burr, Inc., have raised serious questions whether competitive conditions could be maintained if an unconditional exemption from competitive bidding was granted. In its original application filed in this proceeding in October, 1948, Central Maine proposed to issue and sell 303,330 shares of common stock. The company proposed to negotiate solely with Coffin & Burr for the underwriting of the offering and requested an exemption from the competitive bidding requirements of Rule U-50 for that purpose. It appears that Coffin & Burr has acted as a principal investment banker and financial adviser for Central Maine for over 25 years and may properly be characterized as Central Maine's customary or historical banker.

The record in this case shows that prior to the hearing on the original application and prior to securing authorization, formal or otherwise, to enter into a negotiated transaction, the company entered into detailed negotiations with Coffin & Burr as to the terms of the proposed underwriting. The record also shows that while the original application was pending the company conducted field trips to permit underwriters, dealers, and institutional investors to inspect its plant and territory. The invitations to participate in such trips were issued in each case by Coffin & Burr pursuant to an arrangement with the company. These negotiations and activities were inconsistent with the policy announced by us in the *New England Gas and Electric Association* case decided in January, 1948 [where it was said]:

"We now announce that it shall hereafter be our policy to deny summarily any application for exemption from the competitive bidding requirements of Rule U-50 where competitive bidding is *prima facie* required and the applicant has, before obtaining an authorization from this Commission, entered into any discussions or any negotiations with

respect to the terms of sale with any prospective purchaser of its securities."

After the hearing on the original application at which the above facts were made a matter of record but before the issuance of an order thereon, an amendment was filed. This second proposal eliminated the underwriting of the offering, but proposed that dealers be paid a fee for soliciting subscriptions from stockholders at a price to be fixed by the company and that a firm to act as manager of the solicitation be selected by the company on the basis of information received in response to written requests mailed to six investment bankers. Despite the risk free character of the transaction and the substantial compensation involved, only Coffin & Burr offered to act as manager of the solicitation program for the stock. Prior to a hearing on this second proposal, but after discussions with our staff, the application was further amended to the form presently before us. The record developed at the hearing on the present proposal shows that the company represents that it will negotiate with five investment bankers, of which Coffin & Burr is not one.

Considering the history of this case as outlined above, we doubt whether competitive conditions could be maintained if the company intended to include Coffin & Burr among the underwriters with whom it proposed to negotiate. Upon the assumption that the company does not deal with Coffin & Burr as an underwriter in the proposed transaction and that competitive conditions are otherwise maintained, we are of the opinion, giving weight to the fact that the company's last attempt to sell common stock at competitive bidding was unsuccessful and in the light of its history and earnings' record since that time, that the proposed transaction falls within the conditions for exemption from Rule U-50 specified in paragraph (a) (5) thereof, and that the requested exemption should therefore be granted.

. . . .

. . . Therefore, in accordance with the provisions of the third sentence of Section 6 (b) of the Act, we shall exempt the issue and sale of such stock by the applicant from the provisions of Section 6 (a), subject, however, to the terms and conditions prescribed in Rule U-24 and to the following additional terms and conditions which we deem appropriate in the public interest and for the protection of investors or consumers:

1. That the proposed issuance and sale of common stock by Central Maine shall not be consummated until the results of negotiations with prospective underwriters, the price at which the stock is proposed to be sold, the fees or commissions proposed to be paid to underwriters, and the final order of the Public Utilities Commission of Maine with respect to the proposed transaction have been made a matter of record in these proceedings and a further order shall have been entered by the Commission in the light of the record so completed, which order may contain further terms and conditions as may then be deemed appropriate, jurisdiction being reserved for such purpose; and

2. That jurisdiction be reserved with regard to the payment of all other fees and expenses incurred or to be incurred in connection with the proposed transactions.

McKellar Automatic Machine Company

In the fall of 1947, Mr. Clyde Webb, assistant to the president of McKellar Automatic Machine Company, was requested to investigate whether or not the company should list either its common or its preferred stock, or both, on the New York Curb Exchange. Currently both issues were unlisted.

The McKellar Automatic Machine Company had been organized in Massachusetts in the 1890's and until 1946 was closely held by two family groups. In early 1946, in anticipation of a public offering, the par value of the common shares was reduced from $100 to $5 per share and the number of authorized shares increased from 25,000 to 1,000,000. New common shares were exchanged for old on the basis of 15 new for one old, or 18,750 old shares for 281,250 new shares, creating a paid-in surplus and leaving 718,750 shares authorized but not outstanding.

Shortly after this recapitalization, in March, 1946, the company sold 87,500 new common shares, and as a part of the same offering one of the family interests sold 49,250 shares, making a total of 136,750 shares sold to the public through the New York investment house of Fisher, Newton & Company. The price to the public was $8.00, and net proceeds to the company were $7.25 per share.

One year later, in March, 1947, through the same dealer, the company sold 125,000 shares, 5% cumulative preferred, convertible share for share into common, $15 par, at $16.50 per share. The net proceeds to the company of $15 per share, or $1,875,000, were used for expansion of fixed assets and working capital.

Thus, during 1946 and 1947, 261,750 shares of the company's preferred and common stock had been sold. Most of these shares had come into the hands of investors who had previously had no interest in the company.

From time to time during 1947, Mr. Edward Harlow, president of McKellar Automatic Machine Company, received letters from stock brokers in New York urging him to list McKellar's stock on the New York Curb Exchange. In February, 1948, he also received a statement (Appendix 1 [p. 220]) from an official of the New York Curb Exchange which gave that organization's statement of the advantages of listing on the Curb.

These communications prompted Mr. Harlow to ask his assistant, Mr. Clyde Webb, to investigate the proposal fully. Mr. Harlow explained that, while no immediate expansion of the company was contemplated, the directors were agreed that the company should be ready to acquire any complementary concern if the opportunity should arise. Mr. Harlow thought that any such expansion would probably be financed by selling common stock to the public. He thought that such financing would be easier if the present shares were widely distributed and had a wide market following. As one consideration in the matter, therefore, Mr. Harlow wanted Mr. Webb to investigate whether listing would increase the ease of selling additional shares.

Mr. Harlow reminded Mr. Webb that the controlling interests had no desire to liquidate their holdings further in the near future but that this aspect of the matter deserved consideration as a long-run possibility.

Mr. Harlow had found that the initial cost of listing for McKellar would be $3,500. Most of this sum would be used to prepare for the SEC the registration statement necessary before listing. Since a similar registration statement had recently been prepared in connection with the issues of stock, the work would not be difficult and there could be no question of releasing information not previously made public.

Mr. Webb, feeling that there were probably many aspects of this problem of which he was not aware, made arrangements to interview men connected with the securities business in New York.

The first man he interviewed was Mr. Ernest Kilman of the firm of Kilman, Luther & Pringle, prominent over-the-counter dealers. Mr. Webb came to the conclusion that Mr. Kilman favored listing only for those securities which were widely distributed and were often bought and sold. On the other hand, when he interviewed Mr. Cameron, an official of the New York Curb Exchange, he received a much different opinion on the subject. He was referred to a number of other people, one of whom was a Mr. Doherty, an investment supervisor for a large trust company. Here he received still another viewpoint toward listed

Exhibit 1

NEW YORK CURB EXCHANGE
1M 8-48

LISTING FORM K
(10-30-45)

DISTRIBUTION OF STOCK

(Separate form to be made out for each class of stock applied for)

McKELLAR AUTOMATIC MACHINE COMPANY
(Name of Company)

Distribution of Common (Class) Stock

on September 11, 1947

I, Edward Harlow (Name) President (Title), of McKellar Automatic Machine Company (Company), hereby certify that of the 368,750 (Amount) outstanding shares of Common (Class) stock of the McKellar Automatic Machine Company (Company) there are 179,494 (See Note A Below) shares held by the Public, exclusive of Officers, Directors, and Underwriters, which publicly held shares are distributed among 963 (Number) stockholders, and not pooled, in escrow, non-transferable or restricted as to sale in any manner whatsoever.

NOTE A—The ten highest holders of the 179,494 (Amount) shares certified above as publicly held are as follows:

	Name	Shares			Name	Shares	
1.	The Benson Co.	2,981	shares	6.	Jacob King	2,056	shares
2.	P. T. Kantz	2,906	"	7.	Harold C. Macklin	1,875	"
3.	Ernest T. Baxter	2,500	"	8.	Stanley Rhodes	1,875	"
4.	Emma Ford	2,500	"	9.	Isaac Norwalk	1,875	"
5.	Robert E. Hanna	2,250	"	10.	**Rice & Co.	1,875	"

The 189,256 share difference (*i. e.*, difference between outstanding amount and amount certified above as publicly distributed) is held by 14* (Number) stockholders as follows:

(Show below holdings of officers, directors, underwriters or others in the "non-public" category. Also include below any outstanding shares which are restricted as to sale, and in center column state that such restriction is the reason for the inclusion of such holdings in this groupng.)

Name	*Official Relationship to Company*	*Holdings*
Karl Harlow	Chairman, Board of Directors	119,095
Edward Harlow	President and Director	15,245
Eric Phelps	Treasurer and Director	2,706
D. R. Logan	Clerk and Director	1,069
Percy Sandler	Director	125
Dale Harlow		1,187
Alfred Shaw	Vice President	25,000
Mervin McMillan	Director	2,062
Gordon F. Walker	Director	5,219
Charles C. Lloyd	Director	562
Drew King	Vice President and Director	937
Rudolph Howe	Director	3,862
Raymond Hobbs	General Partner, Fisher, Newton and Company	1,312
Charles F. Grace	General Partner and Director, Fisher, Newton and Company	2,625
Treasury Shares		8,250
		189,256

*Fisher, Newton & Co. owned of record but not beneficially 23,956 shares
**Investment dealers

(*See other side*)

Exhibit 1—Continued

NEW YORK CURB EXCHANGE

LISTING FORM K
(10-30-45)

DISTRIBUTION OF STOCK

(Separate form to be made out for each class of stock applied for)

McKELLAR AUTOMATIC MACHINE COMPANY

Distribution of Common Stock

on September 11, 1947

			Shares
272	Holders of	1 – 99 share lots – – –	14,566
340	" "	100 " " – – –	34,000
206	" "	101 – 200 " " – – –	32,560
62	" "	201 – 300 " " – – –	14,056
26	" "	301 – 400 " " – – –	8,762
23	" "	401 – 500 " " – – –	10,425
26	" "	501 – 1000 " " – – –	21,900
22	" "	1001 – up " " – – –	232,481
977	Stockholders	Total Shares	368,750*

* This figure should be the total of all outstanding shares.

Is any of the .... (Class) stock pooled, deposited in escrow, non-transferable or held under any syndicate, agreement or control? ....

If so, state the number of shares ...., and attach detailed explanation, including certified copies of all agreements relating thereto.

Certified Correct,

By ....

(SEE OTHER SIDE)

Exhibit 2

NEW YORK CURB EXCHANGE
1M 8-48

LISTING FORM K
(10-30-45)

DISTRIBUTION OF STOCK

(Separate form to be made out for each class of stock applied for)

McKELLAR AUTOMATIC MACHINE COMPANY
(Name of Company)

Distribution of Preferred (Class) Stock

on March 25, 1948

I, Edward Harlow (Name) President (Title), of McKellar Automatic Machine Company (Company), hereby certify that of the 125,000 (Amount) outstanding shares of preferred (Class) stock of the McKellar Automatic Machine Company (Company) there are 125,000 (See Note A Below) shares held by the Public, exclusive of Officers, Directors, and Underwriters, which publicly held shares are distributed among 934 (Number) stockholders, and not pooled, in escrow, non-transferable or restricted as to sale in any manner whatsoever.

NOTE A—The ten highest holders of the 125,000 (Amount) shares certified above as publicly held are as follows:

	Name	Shares		Name	Shares
1.	*Faber & Co.	2,500 shares	6.	George N. Hemming	1,250 shares
2.	American Life Ins. Co.	1,875 "	7.	Edna P. Driscoll	1,250 "
3.	*Dunn & Layton	1,500 "	8.	M. I. Cushing	1,250 "
4.	*B. A. Parker & Co.	1,500 "	9.	Evelyn Brady	1,250 "
5.	*Riddle, Sendler & Co.	1,312 "	10.	*Foster McMillan & Co.	1,070 "

The 0 share difference (*i. e.*, difference between outstanding amount and amount certified above as publicly distributed) is held by .... (Number) stockholders as follows:

(Show below holdings of officers, directors, underwriters or others in the "non-public" category. Also include below any outstanding shares which are restricted as to sale, and in center column state that such restriction is the reason for the inclusion of such holdings in this groupng.)

Name	*Official Relationship to Company*	*Holdings*

Certified Correct,

By..

(SEE OTHER SIDE)

*Investment dealers

Exhibit 2—Continued

NEW YORK CURB EXCHANGE

LISTING FORM K
(10-30-45)

DISTRIBUTION OF STOCK

(Separate form to be made out for each class of stock applied for)

McKELLAR AUTOMATIC MACHINE COMPANY

Distribution of Preferred Stock

on March 25, 1948

			Shares
393	Holders of	1 - 99 share lots - - -	21,076
302	" "	100 " " - - -	30,200
136	" "	101 - 200 " " - - -	24,882
65	" "	201 - 300 " " - - -	17,232
10	" "	301 - 400 " " - - -	3,237
9	" "	401 - 500 " " - - -	4,375
13	" "	501 - 1000 " " - - -	12,560
6	" "	1001 - up " " - - -	11,438
934	Stockholders	Total Shares	125,000*

* This figure should be the total of all outstanding shares.

Is any of the .... (Class) stock pooled, deposited in escrow, non-transferable or held under any syndicate, agreement or control? ....

If so, state the number of shares ...., and attach detailed explanation, including certified copies of all agreements relating thereto.

Certified Correct,

By............

(SEE OTHER SIDE)

and unlisted securities. Mr. Webb's notes on these interviews are found in Appendix 2 (p. 222).

After the trip, Mr. Webb realized that he should make a careful study of the ownership of the company's shares. Accordingly, Mr. Webb asked the transfer agents[1] for the securities for lists of common and preferred shareholders. After receiving the lists he had them summarized. Exhibits 1 and 2 follow the forms provided by the New York Curb Exchange to accompany a listing application. Exhibit 3 presents certain information graphically.

Mr. Webb knew that he should have some indication of the number of purchase and sale transactions taking place. He did not wish to secure this information from the dealers who were making a market in the

Table 1

McKELLAR AUTOMATIC MACHINE COMPANY

NUMBER OF STOCK TRANSFERS RECORDED WITH TRANSFER AGENTS FROM SEPTEMBER 11, 1947, TO APRIL 1, 1948

	Common	*Preferred*
First National Commercial Bank	278	28
National Industrial Development Bank	309	135
	587	163

stocks because he felt that they might hesitate to give information which might indicate a case for listing. Therefore, he asked the transfer agents for the number of transactions that had been recorded in each class of stock over the last few months. He realized that such data did not give a true picture because it did not reveal the amount of activity accomplished through "street certificates,"[2] but the results would be reasonably approximate as dividends were being paid on both the common and preferred shares. The figures appear in Table 1.

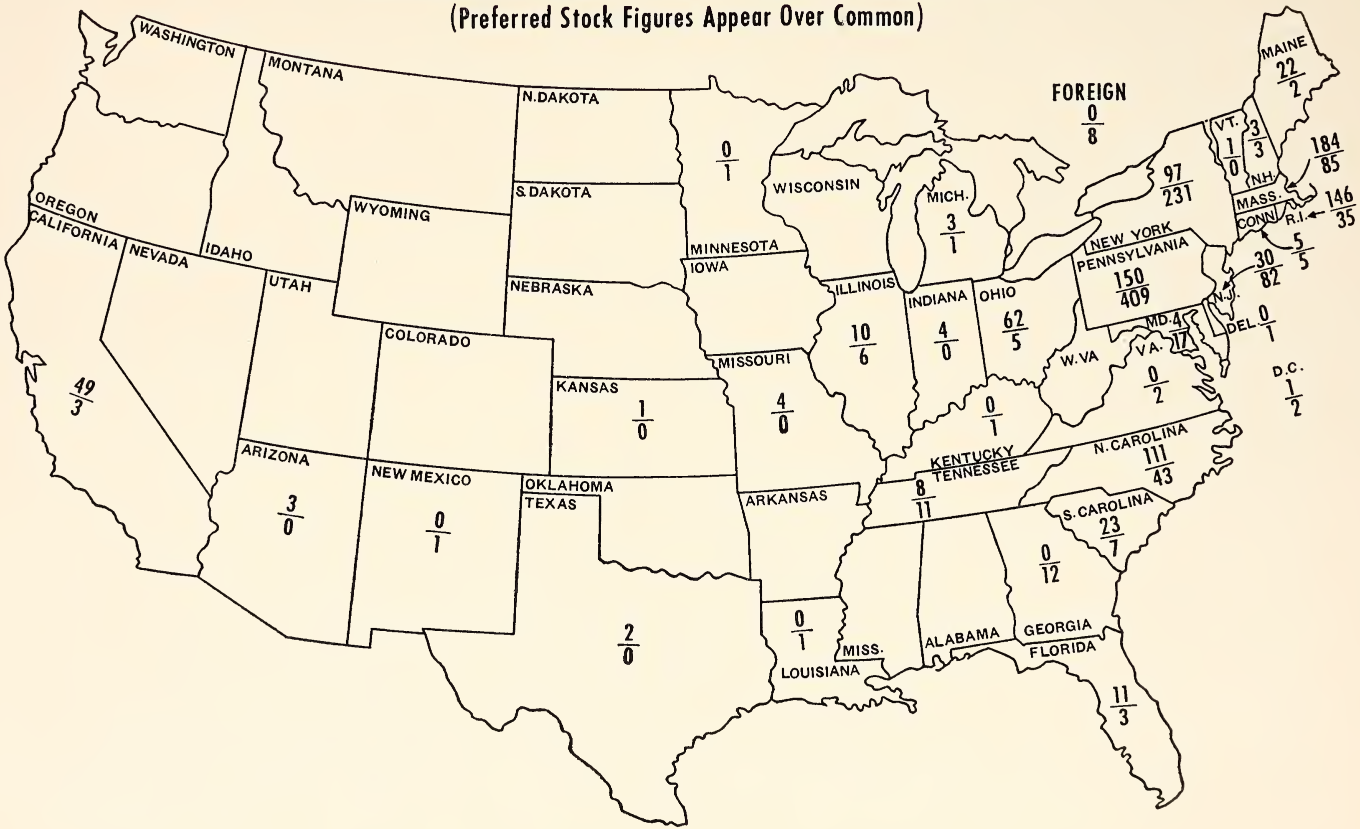
[1] A "transfer agent" is an agency employed to maintain the record of stockholders' names and addresses and to make transfers from one name to another upon receipt of proper orders.

[2] A "street certificate" is a stock certificate that is so registered that it can be bought and sold without reference to the transfer agent.

Exhibit 3

NUMBER OF HOLDERS OF McKELLAR AUTOMATIC MACHINE COMPANY PREFERRED AND COMMON STOCK BY STATES: SEPTEMBER 11, 1947

(Preferred Stock Figures Appear Over Common)



APPENDIX 1

Some Basic Advantages, Corporate, Stockholder, Security, Economic and Public Relations, to Be Gained by Listing Securities on the New York Curb Exchange (Statement of the N.Y.C.E.)

1. The New York Curb Exchange is a primary, highly concentrated, nation-wide, public-auction market for its securities during and after a company's vital "growth period." Complete information concerning these securities is available to the general public through the Exchange and its more than 1,350 member-firm offices located in 360 cities in 46 states and the District of Columbia, as well as through the independent statistical services. In addition, 25 Exchange member-firm offices serve investors in 10 cities outside the United States.

2. This Exchange is also a seasoning market where companies, their securities, managements, products and financial statements are constantly studied by Exchange member-firms and discriminating investors for indications of potential national growth.

3. Operating under strict Exchange and government regulation, our "specialists" and other brokers, acting as "agents" for the public, are held in direct accountability for their business transactions. This protection for both the companies and the investing public is augmented by the timing of the executions of all orders, rapid reporting on the ticker tape, selective membership, audited supervision of member-firms by the Exchange, and experienced member committees ever alert to inconsistent or unsound business practices.

4. The concentration of business volume on one trading floor reduces the unit cost of operation (reflected in minimum brokerage commissions) and establishes in each issue traded a last sale, public appraisal price, made daily in competition with hundreds of other stocks. This price receives widespread publication each business day and is accepted generally as an indication of true value for mergers, consolidations, financial expansion, inheritance taxes, and other purposes and gives investors a constant check on their judgment. This market, where volume is concentrated and transactions closely supervised, makes successful unfair manipulation almost impossible.

5. Securities listed on a nation-wide exchange are more readily acceptable as collateral under normal conditions.

6. The Curb Exchange is an open market because it is not dominated by any individual, firm, or group of firms. It is a free market because anyone with the money or securities which are traded thereon, in

acceptable form, can have orders executed upon it for a minimum commission which is standard and known in advance.

7. The broad geographical distribution of stockholders, which follows (over a period) a listing on this Exchange, minimizes the dangers of too great a concentration of stock in any one area. This is very important in cases of regional business recessions when local security buying power is severely restricted and distress selling depresses prices unduly. Stockholders outside of the depressed area often take advantage of lower prices to acquire bargain stock, thus tending to stabilize exchange prices and therefore collateral values and even local banking conditions.

8. Listing has corporate advertising value through the repetition of the corporate name in the constant reporting of executions on the ticker tape and Trans-Lux machines and quotations over the telephone, teletype, telegraph, and in the leading newspapers of principal cities. When a company's securities become known in national investment circles as familiarly as the company and its products are known through advertising and use, one phase activates the other, with benefits accruing to both.

9. The prestige and public goodwill achieved by listing a stock on a nation-wide exchange emanate from the knowledge that the company has agreed to co-operate fully in supplying information about its business to its stockholders, the exchange, the public, and the government.

10. A very large percentage of the best-known concerns in this country are numbered among the approximately 2,200 securities on the two New York exchanges. About 800 are listed on the Curb and 1,400 on the Stock Exchange.

11. Over 50% of the stocks presently listed on the Stock Exchange, or over 700 issues, won their national following and investment support through Curb Exchange member-firm offices while originally listed on the Curb Exchange. This fact has won for this Exchange the title of Seasoning Exchange for the New York Stock Exchange. About 90% of the Curb Exchange member-firms are also members of the New York Stock Exchange.

12. Investor and broker interest in a new listing on the Curb Exchange is due to the knowledge that some of the most profitable investment opportunities in a company's history occur during its growth period on this Exchange.

13. A listing on the New York Curb Exchange introduces a company to all important investment markets in the country and establishes

a solid foundation for a long-term financial program and goodwill among discriminating investors.

14. Additional shares of a well-known stock listed on a nation-wide exchange can usually be sold for financial expansion more easily and less expensively with a correspondingly greater net return for working capital and corporate purposes. In addition, a considerable saving is realized in the legal expense and detail work necessary for the registration of securities under the blue-sky laws of most other states, through prior listing on the New York Curb Exchange.

APPENDIX 2

Interview with Mr. C. T. Kilman, Partner of Kilman, Luther & Pringle (Prominent Over-the-Counter Dealer)

I explained to Mr. Kilman that we had been approached by the New York Curb Exchange and were currently considering the listing of our securities on that exchange. I also explained that Mr. Harlow had recalled his college friendship with Mr. Kilman and had asked me to get his views on the desirability of our listing with the Curb.

After I explained what I knew about the ownership of our securities and the current volume of trading in them Mr. Kilman expressed the strong feeling that in our situation we would be making a serious mistake in listing on the Curb Exchange. He stated that he thoroughly appreciated the validity of the arguments in favor of listing on one of the exchanges in the case of companies whose securities were well seasoned, widely distributed, and possessed of a widespread market following. Such conditions tended to create an automatic generation of orders for the stock and a resultant satisfactory activity in the stock on the exchange after listing. He cited Dumont Laboratory, makers of television equipment, as an example of a company whose securities are now traded in the over-the-counter market but in such volume and by so many persons that they would unquestionably continue to sell well if listed on an exchange. He stated that between 20 and 25 dealers are actively interested in this stock. It looked to him, however, as if our stock would become an "orphan" if it were listed on the Curb Exchange. He felt that listing our stock would decrease rather than increase interest in it and that a low volume of activity and consequent decline in value would result from listing.

Mr. Kilman explained that his arguments were based on fundamental differences between the trading on the over-the-counter market and

on the organized exchanges. Trading in securities on the exchanges is done through stock *brokers* who act essentially as agents for their clients in executing orders from the client to buy or sell securities on the floor of the exchange. As brokers on the exchange the firms receive for their services a commission or fee according to a schedule established in advance by the rules of the exchange. In contrast, when acting as an over-the-counter dealer, a firm often acts as *principal,* buying or selling on its own behalf. In such transactions the over-the-counter dealer secures remuneration by a spread between the buying and selling price. The latter case can also result in a loss if the trader should guess the trend of the market incorrectly. Margins of profit are not fixed but are generally larger than the commissions allowed brokers. In those instances where the "broker" does not act merely as agent, he must show his position as principal on the bill to his customer. Such a case may arise where the "broker" acts as a specialist (see below). In these instances he often has to take a position in order to keep quotations and trading orderly between wide swings in the market which sometimes occur quickly.

Kilman explained that over 100,000 different securities are traded in by one or more of the several thousand over-the-counter dealers in the country during the course of a year, and more than 7,000 different issues are traded quite actively. Most of the dealers tend to center their interest in a limited number of stocks and to take a "position," usually "long," in the stocks in which they are interested. For example, another dealer might call Kilman's "trader" and ask him if he were interested in buying 100 shares of McKellar at $9\frac{1}{4}$. If Kilman's trader agrees, it is a "deal" without further formality and is consummated in a day or so by delivery of the stock certificates and payment by Kilman. This puts Kilman in a "long position" to the extent of 100 shares. As the owner of these shares, the firm can take any action it desires. Typically, the shares will be treated as an inventory item which should be turned over as rapidly as possible at a moderate profit.

In the securities business as in the commodity markets, there are wholesale and retail dealers. If Kilman, Luther & Pringle is operating as a retail house, a sales force is maintained. If no orders for McKellar stock come in, the salesmen or account men may be notified that the firm is "offering as principals" 100 shares of McKellar at $10\frac{1}{4}$. Such a spread of one point over the purchase price may permit the firm to offer its salesmen a commission of one-half point per share, or $50 on the lot. This stimulates the salesman to aggressive salesmanship in seeking possible

buyers for the security. By seeking out buyers on the telephone or even, in some cases, by "ringing doorbells," the salesman will seek to move the stock. In many cases the firm may advertise the fact that it is offering the particular security at a certain price. As in any other commodity the existence of a relatively high margin permits extensive and aggressive merchandising. In contrast, the maximum return the broker on the Curb Exchange could receive on a 100-share order at approximately 10 would be $17.50. This low fee precludes extensive salesmanship on an individual stock. In other words, there is a real incentive to the over-the-counter dealer to stimulate trading in particular stocks. In the case of a small, not very well-known company, they can set themselves up as being particularly interested in the stock and make arrangements to carry an inventory of the stock and to be in a position to handle buy or sell orders from their customers or possibly from other dealers. Their activities tend to assure a constant market for the securities of the company and, in Mr. Kilman's opinion, help to give the stock the market value that its basic merit warrants.

On the other hand, the listing of a small, not very well-known issue on the Curb Exchange creates a situation in which no broker has any particular incentive to encourage his customers to deal in this particular security. Sale or purchase of it will give him no more commission than would the sale of a very well-known and much more popular stock. Consequently, it had been Mr. Kilman's experience that a number of small, not very widely distributed issues had met with unfavorable experience after listing. After a brief flurry of preliminary interest, such stocks often settled down to weeks of very sporadic activity. In most cases, the prices tended to drift lower than the prices that had been established by the more active buying and selling in the over-the-counter market. Mr. Kilman cited a number of illustrations to prove his point and later sent me further material on these cases so that I could study them at leisure. Excerpts from this material follow:

". . . For years we made a market in the Robson-Mattern Company Common stock, in fact, we were one of the underwriters in 1936. During the time this market was over the counter, we were able to interest dealers in various sections of the country and over a period of time maintained an orderly, close market with stockholders all over the country. The shares traded between $10 and $15 a share, the quotation never exceeded half a point and the spread between sales was usually $\frac{1}{8}$ to $\frac{1}{4}$ of a point. This stock was fairly active, and as I recall, we traded on an aver-

age of about 1,000 shares a week. This, of course, was just our volume and did not represent the trades of other dealers in this stock. Because of pressure on the part of certain stockholders, the bankers had this stock listed on the New York Curb Exchange. The adverse effects were immediately noticeable. There were spreads of half a point to a point between sales, all at lower prices, I might add, and there were intervals of sometimes as much as two weeks between trades. This situation is not uncommon and is easy to explain. Unless you have dealers, and salesmen, if you will, actively engaged in retailing the stock, the amount of interest must diminish. Customers' men cannot afford to devote the time necessary to make these sales merely for a commission. There has to be a greater incentive. Moreover, even if there is no public interest in the shares at the time a sell order is entered, there are usually several "specialists" or trading houses making a market over the counter, all or a few of which will take on some stock for "position." When the shares of a relatively inactive stock are listed, one specialist on the floor takes the place of the several over-the-counter firms. Thus, the normal size of the professional interest is reduced.

"Another case that comes to my mind involves the shares of the Wilkins Supply Company. We made a dealer market in the Common stock of this company for a dozen years or more. It always enjoyed a good, close market and there was a great deal of dealer interest in New England, here in New York, Pennsylvania, and on the west coast. The company listed these shares in the Pittsburgh Stock Exchange, but we continued to make a market over the counter. We believe that 99% of the trading took place over the counter. Sometime in 1946 these shares were listed on the New York Curb, with the identical results as outlined in the Robson-Mattern Company situation.

"I want to make clear that I am definitely of the opinion that there are a lot of stocks traded over the counter that are eligible for listing.

"In 1931 we started an over-the-counter market in the Basic Metals Corporation when they had less than 60 stockholders. In 1937 the company had over 1,000 stockholders and there was a broad, active market in the shares. Here we had a situation where, if a block of stock came in for sale, there was no difficulty in trading it without resorting to dealer distribution. So when the bankers for the company approached me and asked my opinion as to whether the shares should be listed on the New York Stock Exchange, I had to, in all fairness, agree that it was in the best interests of the stockholders to have these shares listed."

In support of his argument that listing by no means insured activity, Mr. Kilman cited some figures from a study made in 1946 for the National Association of Security Dealers.[1]

A record of the trading on the Curb Exchange for a sample of 50 stocks was analyzed as to the volume of trading and the number of days on which they traded during the first full trading week of each quarter of 1946 and during the full month of December, 1946. The analysis showed "that the daily average of issues traded during the January week was 60% of the list, during the April week 58%, during the July week 54%, during the October week 50%. During the full 23 trading sessions studied, the daily average of issues traded was 56% of the list." Forty-six per cent of issues analyzed traded fewer than 11, or about one-half of the 23 sessions; 27 traded fewer than 6, or about one-fourth of the 23 sessions.

Another study during the first 11 months of 1946 showed the number of issues not traded in at all during each month ranged from 36 in January (4.1% of the entire list) to 68 (8%) in November.

He also added that a number of these firms in his opinion would like to get back on the over-the-counter market and off the Curb. However, the regulations of the Securities and Exchange Commission made it necessary for the firm to go through rather extensive formality[2] in order to delist its securities. Consequently, many firms which were dissatisfied with their experience on the Curb had taken no steps to delist. Furthermore, he felt a natural reluctance on the part of the company executives to admit to taking a step that had worked out unfavorably for the holders of the stock.

In regard to the Curb Exchange's general argument, he pointed out that the Curb Exchange as an organization maintained a well-paid staff, who were very effective in presenting the argument in favor of listing. He felt, however, that they were guilty in a number of cases of overselling, that is, of encouraging the listing of securities that would be better left in the hands of the over-the-counter dealers.

He further pointed out that the Curb arguments in regard to certain

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[1] The National Association of Security Dealers is a self-regulatory body of the over-the-counter dealers. Under the Securities Exchange Act such an organization may register with the SEC, and thereby is empowered, with the approval of the Commission, to make and enforce rules and regulations for its members in respect to standards and practices.

[2] SEC regulations require that all the stockholders be notified of the proposal to delist and that a hearing be held by the SEC to see if the action is justified.

abuses of the public interest by over-the-counter dealers were unfair in their implications, since out of a group of more than 4,000 dealers there were bound to be a few black sheep. He insisted that this number was few and that the great bulk of dealers were of such unquestioned integrity as to inspire complete confidence on the part of the public.

Interview with Mr. D. M. Cameron,
(*An Official of the New York Curb Exchange*)

I made myself clear that we conceded the arguments of the Curb to the effect that listing had many advantages for a corporation but that we were not convinced the Curb was better than the over-the-counter market for preparing the ground to receive future issues of stock.

His answer to this statement was that the Curb through member-firms provided over 1,350 centers in 350 cities where transactions in listed securities could be instituted. On the other hand, at the present time McKellar was very fortunate if it had three over-the-counter dealers, probably all located in one geographical area, pushing its stock (actually McKellar has only two dealers pushing its stock, one in New York and one in Pittsburgh).

In answer to my query as to whether its listing would make McKellar an "orphan," he said that when McKellar was first listed and its symbol came across the ticker tape or Trans-Lux machine several times per week or perhaps two or three times in one day, it would be new and strange and would arouse the curiosity of the brokers. They would have the symbol checked and a brief report made on the company by their statistician. He stated that customers' men could suggest purchases of stocks by their clients. He maintained that the majority of the brokers are always interested in new listings because they realize that the Curb carries companies during their growth period. If customers are put in good growth stocks, a broker's reputation is enhanced.

He pointed out that the spread between the bid and asked price on the Curb is much less than that existing on comparable stocks traded on the over-the-counter market.

He asserted that over-the-counter dealers are often foolish. When they first take over a stock to push it they may get a two-point spread;[3] but as this particular stock becomes more generally known to dealers,

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[3] A "spread" is the difference between what a stock is bought for and sold at.

the fact that it is underpriced is realized and dealers will commence to make a market in it. This increase in competition will result in the spread being decreased to the point where it does not compensate the dealer for incurring the risk of taking a position. What such a dealer should do is use his influence to have the stock listed, take out an associate membership on the Curb, which will cost him $2,500, and turn over all his business in the security to a broker from whom he will receive 50% of the brokerage fees involved. In this way he does away with the risk of taking a position on the stock with its small spread and is able to use his capital on "riding" another stock with a two- or three-point spread. Mr. Cameron then gave me some interesting information regarding operations of over-the-counter dealers. (Summarized in Appendix 3 [p. 230].)

In discussing qualifications for listing on the Curb, Cameron stated that he would like to see a minimum of 100,000 "free" shares held by 850 to 1,000 shareholders. Free shares mean those held outside family, controlling, or management groups. His contention was that, if from 800 to 1,000 families owned the shares, their needs and decisions would create sufficient activity in the stock to maintain a free competitive auction market. He thought it might be advantageous to list both preferred and common stocks because that would increase the number of times McKellar's symbol would appear on the ticker. He advised that, if listing was contemplated, it should not be done within eight months before or after a new issue. A time when the stock market is relatively stable should be selected, so that the stock would not be subject to undue pressures.

Mr. Cameron maintained that large violent fluctuations in the price of a listed stock were less likely than when a stock was traded over-the-counter. This is because of the activity of a "specialist" broker, one of whom is assigned to each listed stock by the Exchange. These specialists are charged with maintaining a "fair and orderly" market, which implies "the maintenance of price continuity and the minimizing of the effects of temporary disparity between supply and demand."[4] In other words, if the last sale of a certain stock was consummated at 10, and if, when the next offer of shares was made, there were no buyers in the market, the specialist would be expected not to allow the price to go down to perhaps 7 but would be obligated to supply a bid at $9\frac{1}{2}$ or $9\frac{3}{4}$. This broker is not supposed to interefere with market fluctuations that are due to the mar-

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[4] *New York Stock Exchange Directory and Guide*, Supplementary Material, p. E-195.

ket appraisal of the security but merely with violent price fluctuations that he feels are due to a temporary lack of buyers or sellers in the market.

Interview with Mr. F. M. Doherty of the Investment Department of the Peninsular Trust Company of New York

I questioned him on the policy of the Trust company in regard to investing in unlisted securities.

First, he made the statement that he wouldn't consider investing trust funds in a corporate stock unless it was on the "Big Board" (New York Stock Exchange). Then he said that, occasionally, they purchased stocks that were listed on the Curb. The only securities they bought on the over-the-counter market were government and municipal bonds and bank stocks. He maintained that, in general, unlisted companies were weak and of limited capitalization. If an institution started buying a stock of such a company, it would soon own the concern. It was a matter of volume to them. Furthermore, they want to be able to go in or out of the market without affecting the price. He showed me a list of perhaps 150 stocks they were interested in, all of which were listed on the NYSE. In each company they had from $1,000,000 to $20,000,000 invested for the estates, etc., that the Trust company managed.

He seemed to think that the over-the-counter business often attracted those who were not as reputable as they might be. Hence, a trust company (he emphasized the word "trust") avoided them as much as possible because it was too much trouble to make sure they were getting the best possible prices. However, he said later that they often handle large blocks of stock, especially preferreds, through the over-the-counter dealers but here they have the exchange prices to guide them. He made the comment that the banks were very reluctant to lend money against unlisted securities because they were unable to keep an accurate check of their collateral values with such securities. This lack of published actual prices and volumes also made these stocks unpopular with the "chart reader" investor who was interested in such data for clues as to when to buy or sell.

I had considerable discussion with Doherty and two of his colleagues over the question of stocks selling at a higher price when listed. After deliberation, he stated that unlisted stocks sold from 25% to 35% lower than they would if they were listed. He made an interesting comment at this point that they frequently got away with 50% of the actual value for estate valuation purposes when it came to nonquoted securities.

APPENDIX 3

Summary of Brief of New York Curb Exchange Re: Application to SEC to Extend Unlisted Trading Privileges to Certain Companies, 1944[1]

The principal thesis of the brief, prepared by the Curb Exchange, was that the cost to the public in its dealings over the counter is materially greater than the cost to the public of comparable dealings on the Exchange. It was shown that public *purchasers* bought from dealers within a price range which was very much higher than the price range within which public *sellers* were selling to or through dealers on the same day, and, further, that dealers traded among themselves at prices which ranged in between the prices paid by public purchasers and received by public sellers on the same day, as shown in the following table:

	Average of Daily Lowest and Highest Prices						Average Daily Difference between Lowest and Highest	
	Public Sales		Between Dealers		Public Purchases			
Company	Lowest	Highest	Lowest	Highest	Lowest	Highest	Dealers	Public
Lukens	$10.57	$10.79	$10.81	$11.12	$11.54	$12.21	$0.31	$1.64
Merck	34.29	34.77	34.70	35.31	35.33	36.08	0.61	1.79
Northern	26.39	28.26	27.81	28.76	28.68	30.45	0.95	4.06
Public Service	14.00	14.74	14.56	15.02	15.14	15.99	0.46	1.99
Warner	11.02	11.49	11.34	11.82	12.06	12.82	0.48	1.80

It will be noted in the above table that in each stock the average daily range per share between dealers (from 31 cents in Lukens up to 95 cents in Northern) is a mere fraction of the daily range between the lowest sale and highest purchase prices for transactions made with the public (from $1.64 in Lukens up to $4.06 in Northern).

The above table, being prepared on an averaged basis, tends to conceal some striking examples of concurrent over-the-counter prices. As an illustration, shown below are the actual daily figures for three consecutive days in Public Service:

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[1] Securities and Exchange Commission Release No. 3658, February 20, 1945. Application was denied "the Commission finding that it was not in the public interest . . . to extend privileges to the subject securities as to which there did not exist duties substantially equivalent to all the duties that devolve upon issuers, officers, directors, and 10% stockholders by virtue of the provisions of this Act."

Date	Public Sales Highest Price	Public Sales Lowest Price	Between Dealers Highest Price	Between Dealers Lowest Price	Public Purchases Highest Price	Public Purchases Lowest Price	Range—Public Lowest Sale Highest Purchase
1/14/43	$13.000	$11.973	$13.250	$13.000	$14.375	$13.875	$2.402
1/15/43	13.250	5.000	13.375	13.000	14.500	13.375	9.500
1/16/43	12.967	12.967	13.500	13.125	14.000	13.750	1.033

As seen from the above table some public sellers received on January 15, $5.00 per share (lowest public sale price) while others received $13.25, and public buyers paid from $13.375 to $14.50, and dealers trading among themselves from $13.00 to $13.375. The $5.00 per share price certainly could not be attributed to general market action or trend in the light of the price range in other transactions on the same day and on the preceding and following days. It would be interesting to hear the explanation of the dealer whose indicated spread on the transaction was $8.00 per share, or more than one and a half times the total proceeds of $5.00 per share received by his customers.

In all five stocks a very substantial number of the public purchases and sales were made with dealers acting as principals. The great majority of the shares which the public bought from or sold to these dealers was offset by the dealers on the same day. That is, the public purchased from or sold to a dealer who on the same day effected an offsetting purchase from or sale to a dealer of an equivalent amount of the same stock. In other words, most of the public purchases and sales were offset or "matched" by the dealer in transactions with other dealers.

The dealer's spread represents the cost to his public customer. In matched public purchases the spread ranged up to $2.00 per share for Lukens, approximately $3.00 in Merck, over $2.00 in Northern, approximately $1.50 in Public Service, and over $2.00 in Warner.

Continuing, the brief maintains that the general practice among dealers of offsetting public purchases and sales minimizes the dealers' risks to the extent that they were little, if any, greater than the risks involved in agency transactions executed over the counter or on an exchange. This is evidenced by the fact that, out of a total of 1,756 matched public purchases and 699 matched public sales in all five stocks, only 2% of the purchases and 5% of the sales were matched with another dealer at a loss.

The *average* spread per share in these matched transactions in contrast with the comparable commission rates of the applicant exchange is shown in the following table:

	Over-the-Counter Spread: Matched Public Purchase	Over-the-Counter Spread: Matched Public Sale	Commission on Exchange in Unit of Trading
Lukens	$0.89	$0.27	$0.15
Merck	1.03	0.61	0.22
Northern	1.22	0.48	0.20
Public Service	0.77	0.37	0.20
Warner	0.82	0.33	0.16

It will be noted that the spread in matched public sales is less than that taken in matched public purchases. This is because the proceeds from such sales are usually reinvested by the customer in other securities over the counter, and it is the practice of dealers to obtain a larger part of their profits from the customer's new over-the-counter purchase than from his liquidating sale.

The spreads which the dealers charged their own public customers in transactions offset by such dealers on the same day were only a part of the total cost to the public. In all five stocks there were some three-dealer chains (in which a public seller sold to a dealer, who resold to a second dealer, who resold to a third dealer, who resold to a public purchaser, all in the same day), some two-dealer chains, and some one-dealer chains. In many such chains in the five stocks, one or more agents were involved in addition to the dealers. The total cost to the public in the average chain transaction of each type is set forth in the following table:

	Over-the-Counter Average per Share by Which Purchase Price Exceeded Selling Price on Same Day				Exchange
	4-Dealer Chain	3-Dealer Chain	2-Dealer Chain	1-Dealer Chain	Total Commission of Buyer and Seller
Lukens	...	$1.44	$1.20	$0.79	$0.30
Merck	...	1.77	1.37	0.88	0.44
Northern	...	2.30	1.78	1.09	0.40
Public Service	$1.50	1.14	1.23	0.85	0.40
Warner	...	1.42	1.29	0.94	0.32

The Curb's brief argues that the excess cost borne by the public in its dealings over the counter is directly related to the mechanics of the over-the-counter market. Transactions between dealers account for the majority of the transactions and share volume in all five stocks. The explanation of this significant circumstance is that in stocks actively dealt in over the counter, such as the stocks involved here, the market generally revolves around certain dealers who "make" the market and trade primarily and actively with other dealers. Around this core is a very

much greater number of dealers who trade with the public and offset public transactions with other dealers, usually on the same day. Thus, while the transactions between dealers account for the major part of the trading volume in five stocks, such transactions rarely represent investor interest but are merely the mechanism whereby shares are transferred from public investor to public investor. As has been shown above, the transactions between dealers are made within price ranges which vary materially from the prices concurrently being paid and received by the public.

The "two-market" pattern is reflected in the dual system under which quotations are disseminated for over-the-counter securities. There are the dealer quotations which are carried in the National Daily Quotation Service sheets, and there are the public quotations which are carried for a limited number of securities in certain newspapers.

According to the brief, the National Daily Quotation Service is only available to dealer subscribers and a few institutions. The public does not have access to these quotations. The only quotations available to the public are those carried in a limited number of newspapers. These are not bid and asked prices but rather prices or spreads which are arbitrarily established by various formulae. The effect of the formulae is to lower the bid arbitrarily and/or raise the offer then prevailing in the dealers' market. The spreads between the bid and asked prices as published in the newspapers are generally so wide that most public transactions can be made within such spreads. Consequently, if a customer buys a stock at a slightly lower than the published offered or sells at a slightly higher than the published best price, he is generally satisfied because he does not know, and has no way of ascertaining, that lower offers and higher bids prevailed at the time of his transactions. Public purchasers of each of the above five stocks consistently paid higher prices than the low offered in the National Daily Quotation Service sheets of the same day, and public sellers of each of the five stocks consistently received lower prices than the high bid in such quotation sheets of the same day. The margin of difference between such quotations and prices actually received or paid by the public was very substantial.

The dual system over the counter of two contemporaneous markets (dealers and customers) and two contemporaneous sets of quotations, of which the public has knowledge of one and the dealer of both, and the nonpublication of prices at which purchases and sales are made are characteristics of the over-the-counter market which evolve from the general practice of effecting transactions on a principal basis.

The Curb's brief argues that, in contrast to the over-the-counter market, the Exchange market is a public, competitive market wherein bids of potential buyers and offers of potential sellers are, through broker agents, concentrated at a single focal point in a public competition under auction rules. Transactions are effected as a result of the meeting of the highest bid and lowest offer. All transactions are in the open. The Exchange maintains a quotation system through which a member may know actual quotations bid or asked at any moment. A quotation is a firm bid or offer in at least the unit of trading. It is actual at the time given, not nominal or subject to negotiation. If it is accepted, the member making such a bid or offer is bound by the quoted price.

The Exchange is principally an open agency market. An order given to a member of the Exchange is accepted by that member as agent. The fiduciary relationship then imposes upon the broker definite responsibilities. He may not buy or sell for himself at the same or better price without first executing his customer's order. Rule 5 of the Exchange specifically contemplates that the member must seek the best market for his customers, whether that market be on or off the Exchange. For his services the member is paid a commission known to his customer and established by a public schedule of commissions.

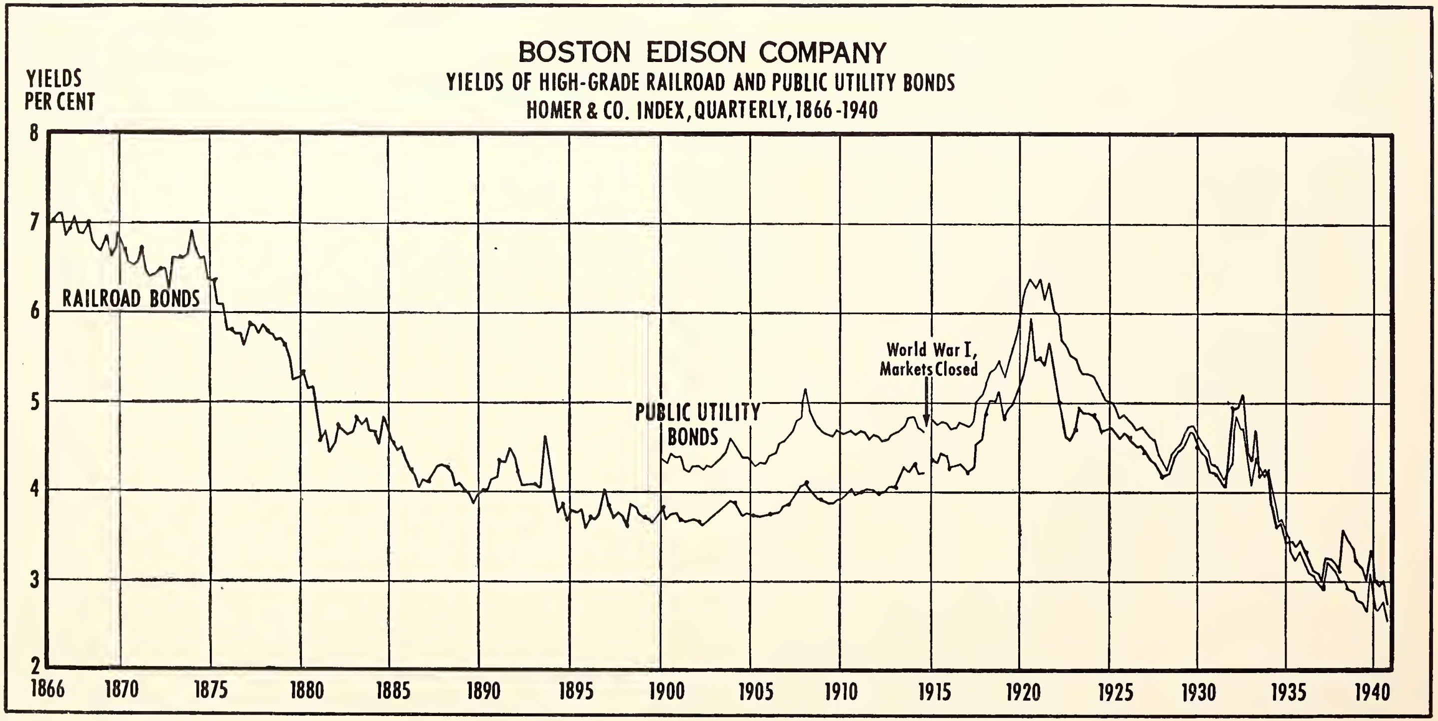
Boston Edison Company

The terms on which new issues of high-grade utility bonds were being issued and on which outstanding issues were being traded in the fall of 1940 appeared to be very favorable for bond financing. As shown in Chart 1, a historical low in yields had been reached. Yields on high-grade corporate bonds had declined more than $\frac{1}{2}\%$ since 1935, when the Boston Edison Company had sold an issue of $53,000,000, par value, of $3\frac{1}{2}\%$ first mortgage bonds maturing July 1, 1965. At that time the bonds were sold at a premium so that net annual cost to the company was 3.39%. The investor's yield to maturity was 3.30%. Because of the decline in yields from 1935 to 1940, it was deemed desirable to refund this issue.

The Boston Edison Company, an operating company engaged in the sale of electricity and steam, in 1940 was supplying electricity directly to approximately 40 communities located over an area of 580 square miles. Electricity in bulk was sold to other electrical companies, municipalities, and very large users. Steam sales were limited to the city of Boston. Other activities included the operation of a radiobroadcasting station and the purchase and sale of electrical appliances. Earnings fluctuated little and did not fall off greatly even during the depression of the early 1930's. Boston Edison bonds were considered by investors as being among the highest quality utility issues available.

In the fall of 1940 the company's investment banker, after considering the state of the market, estimated for planning purposes that the company could at that time sell an issue of 30-year bonds on a 2.70% basis to the public. The rate of interest cost to the company was estimated at 2.76%, allowing for the costs of the issue. On that assumption, a calculation of the savings that would result from the refunding was drawn up and is given in Exhibit 1. In making the estimate, the corporate income tax rate was assumed to be 24% over the 30-year period. The calculation indicated that substantial savings were possible.

Chart 1


BOSTON EDISON COMPANY
YIELDS OF HIGH-GRADE RAILROAD AND PUBLIC UTILITY BONDS
HOMER & CO. INDEX, QUARTERLY, 1866-1940
YIELDS PER CENT
8
7
6
5
4
3
2
RAILROAD BONDS
PUBLIC UTILITY BONDS
World War I, Markets Closed
1866
1870
1875
1880
1885
1890
1895
1900
1905
1910
1915
1920
1925
1930
1935
1940

After it was decided to proceed with the refunding, the Boston Edison Company and its advisors decided upon the details of the indenture of the new issue, such as sinking fund retirement, call prices, and others. The bonds were to bear interest from December 1, 1940, and to be due December 1, 1970.

On November 25, 1940, the Boston Edison Company advertised for competitive bids by bankers for the purchase of the entire issue. Bidders were permitted to bid on the coupon rate of either $2\frac{3}{4}\%$ or 3%. As appears in Exhibit 2, the highest bid, which was the one accepted, was offered by the company's investment banker, the First Boston Corporation. The proposed yield to investors, 2.51%, was lower than previously attempted for issues of this kind.

Public offering took place on December 4. The issue was successful. December 10 was the date of the payment by the underwriters to the Boston Edison Company for the issue. Since the bonds were dated December 1, nine days' interest, or $36,438, was added to the price named in Exhibit 2. On the same date, the company gave the required 30-day notice of redemption of the outstanding first mortgage bonds at 107 and accrued interest to January 10. The sum of $154,583 was allotted to this interest accrual in addition to the interest unpaid to December 10, 1940.

In the 1940 annual report to stockholders, the company commented on the refunding as follows:

> As a result of the refunding and after the amortization of the net balance of the call premium [from the first few years' annual savings in coupon payments], the company will have the use of the money borrowed for [the remainder of the 30 years] at the rate of 2.6%, which is an exceptionally low rate for the bonds of a public utility having a maturity of 30 years.

Exhibit 1

BOSTON EDISON COMPANY

POSSIBLE SAVINGS IN REFUNDING FIRST MORTGAGE BONDS

EXISTING ISSUE:

\$53,000,000	$3\frac{1}{2}$'s due 1965
3,710,000	Call premium at 107 to July 1, 1941. Declining premiums thereafter
\$56,710,000	

ASSUMED REFUNDING ISSUE:

\$54,445,000	3's due 1970
2,662,361	Premium received on price of 104.89 (2.76%)
\$57,107,361	

CASH PROVIDED:

\$ 397,361	Difference between sale and retirement
200,000	*Deduct:* Estimated legal and other costs
154,583	*Deduct:* 30 days' interest, old $3\frac{1}{2}$'s
\$ 42,778	

Annual savings on books, 30-year period, net of taxes:

Savings:		
Annual coupons, old $3\frac{1}{2}$'s		\$1,855,000
Annual coupons, new 3's		1,633,350
Savings in interest		\$ 221,650
Amortized premium on sale of new 3's (\$2,662,361 ÷ 30 years)		88,745
Gross gain per year		\$ 310,395
Costs:		
Call premium on old $3\frac{1}{2}$'s	\$3,710,000	
30 days' interest, old $3\frac{1}{2}$'s	154,583*	
Legal and other costs	200,000	
	\$4,064,583	
Amortized costs (\$4,064,583 ÷ 30)		135,486
Net savings before taxes		\$ 174,909
Less: Taxes at 24%		41,978
Net savings after taxes		\$ 132,931

* The "old" bonds would not be called until after the successful sale of the new issue. Thirty days' notice was required, with interest to accrue until the date of payment.

Exhibit 2

BOSTON EDISON COMPANY

Bids Submitted December 2, 1940, for $53,000,000 Refunding Bonds Due 1970

	First Boston Corporation	*Halsey, Stuart & Co., Inc.*		*Salomon Bros. & Hutzler Dick & Merle-Smith*	
Coupon rate	$2\frac{3}{4}$%	$2\frac{3}{4}$%	3%	$2\frac{3}{4}$%	3%
Price to company:					
Per cent	103.525	102.11	107.30	101.835	106.985
Amount	$54,868,250	$54,118,300	$56,869,000	$53,972,550	$56,702,050
Interest cost	2.58%	2.65%	2.65%	2.66%	2.66%
Price to public:					
Per cent	105.00	103.11	108.30	102.185	107.335
Amount	$55,650,000	$54,648,300	$57,399,000	$54,158,050	$56,887,550
Yield	2.51%	2.60%	2.60%	2.64%	2.64%

Source: Securities and Exchange Commission, Correction to Holding Company Act Release, No. 2441, December 19, 1940.

Loose-Wiles Biscuit Company

Under date of July 8, 1935, the president of Loose-Wiles Biscuit Company wrote the stockholders that "your directors believe that the present is a favorable time to refund the corporation's Seven Per Cent First Preferred Stock by means of a preferred stock issue with a lower dividend rate. This is made possible not only by current money market conditions, which have changed materially since the present preferred stock was issued, but by the high credit standing of the corporation. . . ." At the time, 35,008 shares of $100 par 7% cumulative preferred stock were outstanding. The stock was callable on 60 days' notice at 120 plus accrued dividends.

On August 14, 1935, the company offered to the holders of the 7% preferred the right to subscribe pro rata to a new issue of 5% preferred stock at 101. The proceeds were to be used to retire the 7% preferred on October 1. The offer to the shareholders of the 7% preferred was good for 10 days. A group of investment banking firms agreed to purchase those shares not taken up by the old stockholders. In return the bankers received a stand-by underwriting fee of $1.50 for each share sold to the holders of the old 7% preferred stock or $2.00 per share for each share purchased by them. The offering proved successful, with a substantial portion of the offering taken up by holders of the 7% preferred. The 7% preferred was retired on October 1. In addition to an outlay of $700,160 for call premium on the 7% preferred stock retired, the company incurred total expenses of $162,167 in connection with the call of the old stock and issue of the new. However, the new stock was sold at a premium of $42,000. The expenses of refunding the preferred issue and the premium on the new preferred stock did not affect taxable income for the year.

The first trading in the new 5% preferred stock on the New York Stock Exchange was at a substantial premium above the offering price

to the old stockholders. During the remainder of 1935 the 5% preferred stock ranged between a low of $107\frac{3}{4}$ and a high of 112.

On June 16, 1941, the company sold an issue of $4,000,000 of unsecured promissory notes at face value to the Prudential Insurance Company of America. The notes were due serially to 1956 and carried an interest rate of 3%. The proceeds of the sale of the notes, together with funds from the company's treasury, were used to retire the entire issue of the company's 5% preferred stock. The issue was called at 105 on July 1, 1941.

Bebb Corporation

In April, 1942, the management of the Bebb Corporation, a manufacturer of kraft paper, corrugated board, and boxes widely used for many commercial purposes, had arranged with two banks for loans to provide working capital to finance a volume of sales in excess of that which had been anticipated. At the same time as the working capital question arose, the management was considering whether under the circumstances it should continue to appropriate funds for the purchase and subsequent retirement of the preferred stocks of the company. If such a policy were to be continued, the company would be required to decide whether it should continue purchasing shares in small lots from time to time or should call the entire issue of the outstanding preferred stocks, at the redemption price. In the latter case, some sort of a refunding issue would be necessary.

Balance sheets and earnings statements of the company for the years 1939–1941 will be found in Exhibits 1 and 2, together with a summary of income figures from 1929 through 1938 and the current position at March 31, 1942. A change in the efficiency of operation will be noted. In 1939 the company had made a careful study of its production costs and sales margins and subsequently had made substantial changes in policy, the results of which were reflected in the increased rate of earnings in 1940. It was believed that this increase in efficiency could be maintained in future years. On such a basis, the management felt that, at an annual sales volume of $14,000,000, net profits would be adequate to provide for suitable dividends on all classes of stock. Plans in regard to financial needs had been made in 1939 on the assumption that an annual sales volume of $14,000,000 was a practical goal, at least in the foreseeable future. There would be no need to force sales, by cutting margins, to reach higher totals.

In handling $14,000,000 annual sales the company had normally borrowed about $600,000 for four peak months, September through December. Bank credit for these seasonal loans and occasional temporary loans to permit the purchase of blocks of the company's own stock had been obtained without difficulty. All such loans had been repaid promptly out of seasonal liquidation or out of earnings. The company maintained principal banking relationships with two large city banks and had regularly been told by them that its credit was so strong that the seasonal loans requested were well within the limit that the company would be able to borrow.

The coming of the defense program and the war had led to an increased volume of orders for the standard products of the company. Some novelty lines with low margins had been cut out in an attempt to keep the volume of sales down to the budgeted $14,000,000 a year, but demands for special types of containers for military use developed so rapidly that sales for 1941 were approximately $19,500,000. During the first three months of 1942 the sales of the Bebb Corporation were $5,456,000, an increase of $1,272,000 over the same period in 1941. Unfilled orders at April 1 totaled $4,104,000, slightly less than the previous year; but it was estimated that the year's sales would exceed the 1941 rate. The rate of profits on sales was about the same as 1941.

The treasurer's budget of working capital needs, based on such a volume, indicated that the company would need to borrow heavily for the fall. The maximum loan for financing working capital requirements at that time would amount to about $1,200,000; and, so long as the volume of sales was maintained at approximately $20,000,000 a year, a minimum of about $600,000 would need to be borrowed even at the low point of the year.

Pending a determination of the question, the treasurer of the company had not included in his budget any provision for the continued purchase of shares of the company, as had been a recent policy.

The treasurer's preliminary negotiations with financial institutions had developed the following facts. Each of the company's two banks was willing to extend a line of credit to the company for the needed working capital funds. The exact amount of the maximum line that would be available was not mentioned, but the treasurer thought $1,200,000 could be borrowed without difficulty and without pressure for prompt liquidation. It was understood that the loan would rotate from bank to bank on a six-months basis so that neither bank would carry the

company's debt continually. The rate of interest would be $1\frac{1}{2}\%$ per year initially but would vary as the level of interest rates might change.

In addition, the treasurer had talked with investment bankers about refunding the two types of preferred stock outstanding with an issue of 20-year debenture bonds. It was understood that a $6,000,000 issue of bonds with a $4\frac{3}{4}\%$ coupon could be sold to net the company the par price. Although details had not been worked out, the bankers had stated that three provisions would have to be included in the indenture: (1) that all debt, current and fixed, should not exceed 175% of the current assets; (2) that the company could not mortgage any property while any of the bonds were outstanding; (3) that the bonds would be callable in whole or in part at 105% of the public issue price.

The first preferred stock and the common stock of the company were listed on an organized exchange and were widely held, although infrequently traded. The 7% preferred stock was unlisted and had been almost completely inactive since 1939.

In recent years the company had begun to acquire shares of various classes of its stock, in the open market and through occasional tender offers, as part of a plan to simplify its capital structure and to reduce its outstanding capitalization by the retirement of the stock so purchased. The number of shares of the various classes of stock acquired and the average prices paid, in the years 1940 and 1941, are tabulated below:

	1940		*1941*	
Class of Stock	*No. of Shares Acquired*	*Average Cost*	*No. of Shares Acquired*	*Average Cost*
1. 8% first preferred	830	$96.91	6,530	$118.75
2. 7% preferred	980	80.51	730	111.93
3. Common	52,000	4.28	6,200	3.88

By April 1, 1942, it was clear that few, if any, more shares of the 7% preferred stock could be obtained without call. Blocks of shares of first preferred stock continued to come on the market from time to time, principally from trust accounts and estates which desired to liquidate some of their investments. The only quotation so far recorded in 1942 was in the week of March 16, at $123 per share. The number of shares traded that week was 10.

The provisions of the capital stock issues are summarized in Exhibit 3.

On February 1 the company paid a regular quarterly dividend (2%) on the first preferred stock. The arrears ($82 per share) on the

small number of shares of 7% preferred stock were partly paid up in 1941 and fully paid up March 31, 1942, by payment of $4,303 on that date. One of the reasons for this payment was to clear the way for possible payments on common stock in the ensuing quarters. At April 1, 1942, there were no arrearages on either preferred stock. There had been no dividends paid on the common stocks since 1932. The current position of the company on March 31, 1942, was as shown in Exhibit 1.

Exhibit 1

BEBB CORPORATION

BALANCE SHEETS AS OF DECEMBER 31, 1939–1941, AND CURRENT POSITION MARCH 31, 1942

(Dollar figures in thousands)

	1939	1939	1940	1940	1941	1941	Mar. 31 1942
ASSETS							
Cash and deposits		$ 882		$ 1,893		$ 801	$1,429
U.S. tax anticipation notes		.....		5		74	84
Accounts receivable		2,275		2,119		3,080	1,953
Inventories*		2,456		2,590		3,705	4,136
Current assets		$ 5,613		$ 6,607		$ 7,660	$7,602
Stock of subsidiaries, etc.†		962		855		350	
Land†		201		198		438	
Buildings, machinery, and equipment†	$10,624		$10,683		$11,031		
Allowance for depreciation	6,920	3,704	7,240	3,443	7,677	3,354	
Deferred charges and supplies		201		237		330	
Total assets		$10,631		$11,340		$12,132	
LIABILITIES AND CAPITAL							
Accounts payable		$ 510		$ 488		$ 711	$ 517
Accruals		253		303		436	756
Estimated income tax liability		93		526		1,842	1,877
Current liabilities		$ 856		$ 1,317		$ 2,989	$3,150
8% first pfd. stock, par $100		4,584	$ 4,584		$ 4,584		
Par value in treasury		.....	83‡	4,501	736‡	3,848	
7% preferred stock, par $100		183	$ 183		$ 183		
Par value in treasury		.....	98‡	85	171‡	12	
Common stock, par $5		2,120	$ 2,120		$ 2,120		
Par value in treasury		.....	260‡	1,860	291‡	1,829	
Difference between par value and cost of treasury stock		.....		59		65‡	
Surplus		2,938		3,518		3,519	
Total liabilities		$10,681		$11,340		$12,132	

* Lower of first-in first-out cost or market.
† Cost.
‡ Debit figure.

Exhibit 2

BEBB CORPORATION

SUMMARY INCOME STATEMENTS, YEARS 1929–1938
INCOME STATEMENTS, YEARS 1939–1941, AND FIRST QUARTER, 1942
(Dollar figures in thousands)

				Dividends Paid		
Year	Sales	Net Income before Taxes	Net Income after Taxes	1st Pfd. Par $100	7% Pfd. Par $100	Common Stock Par $5
1929	$18,670	$1,671	$1,487	$765	$207	..
1930	15,884	642	565	384	224	..
1931	12,894	370[d]	370[d]	384	239	14
1932	9,516	561[d]	561[d]	95	...	..
1933	9,324	79	69	189	...	..
1934	11,653	595	520	468	...	..
1935	12,202	655	573	366	...	..
1936	13,546	871	741	642	...	..
1937	14,413	628	532	459	30	..
1938	13,305	99	82	366	...	..

[d] Deficit.

	1939	1940	1941	1st Quarter 1942
Sales	$14,643	$14,690	$19,445	
Cost of goods sold*	9,448	9,039	11,976	
Gross profits	$ 5,195	$ 5,651	$ 7,469	Figures
Selling and administrative expense*	4,600	4,203	4,798	Not
Operating profit	$ 595	$ 1,448	$ 2,671	Yet Available
Other income	14	8	57	
Other expense	107	41	29	
Net income before income tax	$ 502	$ 1,415	$ 2,699	
Estimated income tax	94	359	565	
Estimated excess profits tax	.....	169	1,182	
Net income available for dividends	$ 408	$ 887	$ 952	
Dividends paid:				
8% first preferred stock	$ 366	$ 365	$ 332	$77
7% preferred stock	.....	.....	6	4
Total dividends paid	$ 366	$ 365	$ 338	$81

* Depreciation expense included.

Exhibit 3

BEBB CORPORATION

CERTAIN PROVISIONS OF OUTSTANDING CAPITAL STOCK, APRIL 1, 1942

<table>
<tr><th></th><th>8% 1st Pfd. Stock
Par $100</th><th>7% Pfd. Stock
Par $100</th><th>Common Stock
Par $5</th></tr>
<tr><td>ACTUALLY OUTSTANDING</td><td>38,480 shares</td><td>120 shares</td><td>365,800 shares</td></tr>
<tr><td>REDEMPTION PROVISIONS</td><td>Whole outstanding issue callable on 90 days' notice at $150 and accumulated dividends. Not redeemable in part.</td><td>Whole outstanding issue callable on 90 days' notice at $115 and accumulated dividends. Not redeemable in part.</td><td>None</td></tr>
<tr><td>SINKING FUND PROVISIONS</td><td colspan="2">In any year at least 5% of earnings after preferred dividends must be used to purchase preferred stocks.
So long as interest and sinking fund charges on any funded debt and cumulative dividend requirements for all classes of preferred exceed $300,000 annually, company must pay no common dividends without allotting a sum equal to one-fourth of common dividend for the reduction of debt or the purchase of first preferred shares. At least one-half the allotment must be used to purchase first preferred stock. Also, at least one-fourth of the common dividend must be paid in stock.</td><td>None</td></tr>
<tr><td>VOTING POWER</td><td>Obtains 10 votes per share whenever dividends are $12 or more in arrears and also the right to elect two-thirds of the Board of Directors. Otherwise, does not vote.</td><td>None</td><td>One vote per share.</td></tr>
<tr><td>DIVIDEND PRIORITY</td><td>8%, senior to all other classes, fully cumulative.</td><td>Junior to first preferred, senior to all others. 7% fully cumulative.</td><td>Dividends may not be paid unless remaining surplus would amount to at least one year's dividend requirement on both preferred stocks.</td></tr>
<tr><td>DIVIDEND RECORD</td><td>No arrearages. Dividends not paid in 1932 and part of 1933 were fully made up by the end of 1937.</td><td>No regular dividend since 1931. Arrearages all paid up by April 1, 1942.</td><td>No dividend since 1932.</td></tr>
</table>

American Woolen Company[1]

In June, 1946, the preferred and common stockholders of the American Woolen Company were asked to approve a plan of recapitalization proposed by the directors of the company. Since the plan involved basic changes in the company's Articles of Incorporation, the approval of stockholders owning two-thirds of each class of stock—preferred and common—was required.

The recapitalization plan sought to eliminate dividend arrearages on the 350,000 shares of 7% cumulative, noncallable, preferred stock outstanding. Elimination of the arrearages, which on June 3, 1946, amounted to $20,475,000, or $58.50 per share, would make legally possible the resumption of dividend payments on the 400,000 shares of common stock of the company. The common stockholders had received no dividends for 22 years, the last payment having been in July, 1924.

After many years of low profits or operating deficits, the company had made substantial profits during the war years. Earnings and preferred dividend payments are shown in Exhibit 1 (p. 255). The balance sheet for 1945 is given in Exhibit 2.

In the annual report to stockholders dated February 20, 1946, the president of American Woolen had discussed the problem of the arrearages in the light of recent profitable operations of the company. He said:

> During the 10 years ended December 31, 1945, the company paid dividends totaling $70.00 per share on the Preferred stock, an average of $7.00 per year, which was just enough to keep the Preferred dividends current without reduction of the unpaid accumulations, which were $58.75 on December 31, 1935, and the same amount on December 31, 1945. While some of the years during this 10-year period were years of loss or less than average earnings, the war years were profitable; and the whole period should be regarded as one of more than average pros-

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[1] The material in this case is from various published sources.

perity, with average earnings at least equal to, and probably in excess of, what may be expected during the reconversion period and thereafter. A net reduction of the accumulations on the Preferred stock during the next few years is not impossible, and may even be regarded as probable, but it is highly improbable that earnings will permit the payment of the entire accumulations, which must happen before dividends can be paid on the common stock.

For this and other reasons, and with the benefit of suggestions from many interested stockholders, both Preferred and Common, the Officers and Directors, during the past year and particularly during recent months, have given a great deal of thought and consideration to the question of recapitalization for the purpose of eliminating the accumulated unpaid dividends on the Preferred stock which amounted, as previously stated, to $58.75 per share on December 31, 1945, or a total of $20,562,500. If the many legal technicalities and other difficulties can be satisfactorily overcome, a detailed plan will be submitted to the stockholders for approval at a special meeting to be called for that purpose. The management is hopeful that the problem will be solved, but no definite assurance can be given at this time.

On March 26, 1946, at the annual meeting of stockholders, a tentative plan of recapitalization was disclosed. At the same meeting, according to newspaper reports,[2] President Moses Pendleton said he expected that distribution of at least 75% of earnings would be made in 1946, with the larger part of the payment in the second half of the year.

Despite many uncertainties, operations in the early months of 1946 continued at a high and very profitable rate.

At a special meeting on April 30, the board of directors voted to recommend a revised plan of recapitalization to the stockholders. A letter describing the proposed plan and calling a stockholders' meeting for July 3 to vote on the proposal was mailed on June 3. A major portion of the letter follows:

TO THE STOCKHOLDERS OF
AMERICAN WOOLEN COMPANY:

Accompanying this letter is a Notice of Meeting and Proxy Statement, together with a Proxy, relating to a Special Meeting of Stockholders to be held July 3, 1946. The purpose of the meeting is to consider and take action upon a Plan of Recapitalization of your company.

It has long been apparent that a revision of the capital structure of the company is desirable. As you have been advised in the Annual Reports, this subject has been given almost constant study for the past several years. During this period dozens of plans submitted by stockholders, banking houses, and independent financial experts have been reviewed and a great deal of time and effort has gone

[2] *Commercial and Financial Chronicle,* April 1, 1946.

into the preparation of the Plan now submitted to you. It is presented with the unanimous approval of your Directors as being fair and equitable and in the interest of both Preferred and Common stockholders. Please give it careful consideration and mail in your proxy promptly.

Historical Review

The predecessor American Woolen Company was organized in 1899 and the terms of the present 7% noncallable Preferred stock and the Common stock were created at that time. The history of the company since then falls naturally into three periods. Until shortly after the First World War the company maintained a relatively stable earning power. During the next period, up to the outbreak of the recent war, profit margins declined sharply as a result of price competition induced by the substantial overcapacity that had been built up in the industry, the development of competing fabrics and the increasing competition from woolen imports produced by cheap foreign labor. The present period, beginning with the outbreak of the last World War, saw an abnormal demand for woolen fabrics and the practical elimination of imports so that the company has been able to operate steadily at a high rate of production.

. . . .

The mills are now working at a high rate of capacity and earnings are currently running at a very favorable rate. It is impossible to predict how long these conditions will continue. The Wool Textile Industry in the United States has much too great a productive capacity in relation to the normal demand. English and European mills are making every effort to resume volume production. Once the present world shortage of woolens is satisfied we must look forward to a return of the highly competitive conditions existing prior to the war. The problem of meeting foreign competition under the lower tariffs established in 1939 will be intensified by high labor costs.

The Present Situation

For many years the company has been seriously burdened by the excessive amount of noncallable Preferred stock carrying a fixed dividend rate of 7%. Dividend accumulations on this stock now amount to $20,475,000 and one of the most serious problems confronting the company is the elimination of these dividend accumulations and the correction of the present inflexible capital structure.

The company now has outstanding 350,000 shares of 7% noncallable Preferred stock of $100 par value and 400,000 shares of Common stock without par value. Dividend accumulations on the Preferred stock amount to $58.50 per share, or an aggregate of $20,475,000. The annual dividend requirement on the Preferred stock of $2,450,000 is currently being earned by a wide margin but from the organization of the predecessor company in 1899 through 1942 average earnings were less than the annual dividend requirement on the Preferred stock now outstanding. Even including the high earnings of the past three years, such dividend requirements would have been covered by only a slight margin.

In the opinion of your Directors, the present inflexible and top-heavy capital structure will prove a serious burden unless corrected.

EXCHANGE OF STOCK

The Plan contemplates the creation of a new class of \$4 Cumulative Convertible Prior Preferred stock to be offered in exchange for the present 7% cumulative Preferred stock on the basis of 1½ shares of the new Prior Preference stock, plus \$8.50 in cash, for each share of the present Preferred stock with its right to accrued dividends. The new Prior Preference stock will be without par value; will be preferred over any unexchanged 7% Preferred stock and the Common stock as to dividends to the extent of \$4 per share per year and as to assets to the extent of \$105 per share in voluntary and \$100 per share in involuntary liquidation, in each case plus accrued dividends; will be callable at any time on or after September 15, 1951, at \$105 per share plus accrued dividends; and will be convertible at any time into 2 shares of Common stock. For a more complete statement of the provisions of the new Prior Preference stock, reference is made to the Proxy statement.

ADVANTAGES OF THE NEW CAPITAL STRUCTURE

To the extent exchanges are made pursuant to the Plan, the dividend accumulations on the present Preferred stock will be eliminated without any substantial cash drain upon the company, and, since it is intended to pay promptly accrued dividends on any unexchanged Preferred stock, the way will immediately be opened for dividends upon the Common stock. At the same time regular preferred dividend requirements will be reduced and provision made for the eventual reduction of senior capital either by redemption, or through conversion of the new Prior Preference stock into Common stock.

THE PLAN IN RELATION TO THE PREFERRED STOCKHOLDERS

The holders of the present 7% cumulative Preferred stock now have a first claim upon the earnings of the company to the extent of \$7 per share annually, plus accrued dividends of \$58.50 per share. Furthermore, their present stock is noncallable. Under the Plan they will be offered the right to exchange each share of present Preferred stock with its right to accrued dividends, for 1½ shares of \$4 Prior Preference stock plus \$8.50 in cash. Each share of such stock will be convertible into 2 shares of Common stock and may be redeemed after five years at \$105 per share plus accrued dividends. The new Prior Preference stock received in exchange for each share of present Preferred will have an aggregate dividend preference of \$6 annually.

While the Preferred stockholders who make the exchange will forego any right to receive payment of the accrued dividends on their present stock, and will accept a reduction of \$1 per share in the aggregate dividend rate, they will receive new stock having a liquidation and redemption value, plus cash, equal to or greater than the par value plus accrued dividends of their present stock. Furthermore, each share of the new Prior Preference stock will be convertible into 2 shares of Common stock or a total of 3 shares for the 1½ shares of new Prior Preference stock for which the present Preferred stock may be exchanged. Thus, holders of Preferred stock who make the exchange will place themselves in a position to participate in the future earnings of the company as Common stockholders by converting the new Prior Preference stock into Common stock.

Upon consummation of the Plan it is intended to pay promptly the dividend accumulation on any unexchanged Preferred stock.

A vote in favor of the Plan does not in any way commit a Preferred stockholder to make the exchange. It is intended that, following approval of the Plan and completion of registration, the exchange offer will be made to holders of Preferred stock for a limited period, but acceptance or rejection of the offer will be entirely optional with the stockholder.

THE PLAN IN RELATION TO COMMON STOCKHOLDERS

The Common stockholders now own the entire equity of the company subject to the preferences of the Preferred stock, including the dividend accumulations thereon. However, these preferences are so large that no dividends have been paid on the Common stock since 1924 and no dividends can be paid under the present capital structure until the present dividend accumulations of $20,475,000 have been eliminated. Currently the regular dividend upon the Preferred stock is being earned by a wide margin but the average annual earnings of the company and its predecessor since 1899 have been only slightly in excess of the present annual dividend requirement upon the Preferred stock.

It is impossible to determine how much of the Preferred stock may be exchanged pursuant to the Plan but, to the extent that exchanges are made, the dividend accumulations on such stock will be eliminated and the annual dividend requirement will be reduced by $1 for each share exchanged. To the extent that any new Prior Preference stock may subsequently be converted into Common stock, the amount of Common stock outstanding will be increased at the rate of 2 shares for each share of Prior Preference stock so converted, but this would be accompanied by a proportionate decrease of senior capital now coming ahead of the Common stock.

Upon consummation of the Plan the company intends to pay promptly the accrued dividends on the unexchanged Preferred stock and to initiate dividends on the Common stock. The rate and continuity of Common stock dividends will obviously depend on the trend of earnings but, if the Plan is consummated, the Directors expect to pay dividends on the Common stock of at least $5 a share in 1946.

. . . .

CONCLUSION

After a careful study, the Directors believe that the proposed Plan is in the interests of holders of both classes of stock and recommend that all stockholders vote in favor of the Plan.

Adoption of the Plan will require the affirmative vote of two-thirds of each class of stock outstanding. It is important, therefore, that every stockholder make sure that his stock is represented at the meeting by filling, signing and returning the enclosed Proxy promptly.

[s] M. PENDLETON
President

June 3, 1946

The stockholders convened as scheduled on July 3, with results as described in the *Commercial and Financial Chronicle* of July 15:

> The special meeting of stockholders called to act upon a plan of recapitalization was adjourned on July 3 for two weeks to July 17. Additional time is sought for further stockholder responses to the proposed Plan.
>
> Over 60% of the Common stock and over 75% of the preferred already have registered approval, it was said.
>
> Moses Pendleton, President, stated the Plan would automatically go into effect when holders of 80% of Preferred have deposited their stock and registered their approval of the Plan. He also said that the company is operating at capacity. Terming earnings highly satisfactory, he said that unaudited profits for the first five months of the year, were at a somewhat better annual rate than reported for the first quarter.
>
> Unfilled orders on June 1 were $62,000,000 or almost equivalent to the wartime volume of a year ago.

Exhibit 1

AMERICAN WOOLEN COMPANY

FINANCIAL DATA

(Dollar figures in thousands)

Year	Sales	Net Income after Taxes*	Preferred Divs. Paid per Share	Preferred Divs. in Arrears per Share	Preferred Stock Prices on NYSE High	Preferred Stock Prices on NYSE Low	Common Stock Prices on NYSE High	Common Stock Prices on NYSE Low
1927	†	$ 600	$ 1.25	$ 5.25	86½	46⅞	33⅜	16½
1928	†	1,262[d]	....	12.25	65¾	39	32⅜	14
1929	†	4,228[d]	....	19.25	58¾	15½	27⅞	5⅞
1930	†	4,898[d]	....	26.25	44⅞	15⅝	20¼	5½
1931	†	2,837[d]	....	33.25	40	15¼	11⅞	2⅝
1932	†	7,270[d]	....	40.25	39⅞	15½	10	1⅝
1933	†	7,053	....	47.25	67½	22⅝	17	3½
1934	$ 48,711	5,465[d]	2.50	51.75	83¾	36	17⅛	7
1935	70,317	2,741	....	58.75	68¾	35½	10¾	4⅞
1936	71,023	1,930	4.00	61.75	70¾	52¾	11½	7⅝
1937	75,062	1,855[d]	3.00	65.75	79	25¼	14⅜	3½
1938	42,038	4,912[d]	....	72.75	45	23⅝	7⅜	3¾
1939	64,936	2,312	....	79.75	28⅜	64¾	15¼	3⅝
1940	76,560	3,154	7.00	79.75	61⅜	25½	12	6
1941	145,749	9,175	12.00	74.74	81¼	51	8⅝	3½
1942	196,031	7,039	8.00	73.75	76⅜	51¾	5⅜	3½
1943	197,505	10,810	8.00	72.75	79½	55¼	8⅝	3¾
1944	183,009	7,556	12.00	67.75	107	67½	9½	6⅛
1945	162,680	6,075	16.00	58.75	140	100⅛	31⅞	9
1/1/46–3/31/46 (unaudited)	36,963	3,937	2.00	58.50	1946 J 150	128	57¾	29½
					F 147½	134	51	40
					M 150	138¾	49⅝	41¼
					A 154⅞	142	60⅛	45⅜
					M 168	150	67½	51¼
					J 182½	165	70¾	60¾

* Figures through 1940 are from annual reports. Figures for 1941–1945 are from a registration statement filed in 1946 with the SEC in connection with the recapitalization.
† The company did not disclose sales figures prior to 1934.
[d] Deficit.

Exhibit 2

AMERICAN WOOLEN COMPANY

BALANCE SHEET, DECEMBER 31, 1945

(Dollar figures in thousands)

ASSETS

Cash	$ 23,926
U.S. government securities at cost	5,100
Accounts receivable—net	11,594
Inventories	37,701
Other current assets	1,636
Total current assets	$ 79,957
Inventory in subsidiary	9
Fixed assets—net	22,861
Other assets	1,510
	$104,337

LIABILITIES

Accounts payable—trade	$ 828
Accrued liabilities	3,202
Reserve for federal income taxes	19,361
Reserve for renegotiation refunds	700
Other current liabilities	777
Total current liabilities	$ 24,868
$3\frac{1}{2}\%$ mortgage on real estate	940
Special reserve for war contingencies	9,000
7% preferred stock—350,000 shares outstanding*	35,000
Common stock—400,000 shares—no par at $5.00, stated value	2,000
Capital surplus	21,290
Earned surplus since January 1, 1941	11,239
	$104,337

* Preferred arrearages to date are $20,562,500, or $58.75 per share.

Ohio Gauge Company

In November, 1945, Robert Shea, aged 44, president and principal stockholder of the Ohio Gauge Company, was contemplating the issuance of common stock for the purpose of retiring the company's remaining preferred stock.

Mr. Shea had first become acquainted with the Ohio Gauge Company in October, 1932, when he bought several hundred shares of its common stock. At the time, Mr. Shea was assistant to the president of National Shares, Inc., an investment trust located in New York City. Mr. Shea also engaged in speculation on his own account. He had bought his Ohio Gauge Company shares on the recommendation of a friend, William Hewitt, a securities salesman in the small Wall Street brokerage and investment banking firm of Sutcliffe and Company. Mr. Hewitt, a native of Springdale, Ohio, the city in which the Ohio Gauge Company was located, and a nephew of the company's treasurer, was intimately acquainted with its affairs. Mr. Hewitt was of the opinion that the stock was undervalued at its current over-the-counter price of $1\frac{3}{8}$, which compared with a 1929 high of $25\frac{1}{2}$, and had great potential "leverage" because of its low price and because of dividend arrearages which had been accumulating on an issue of $8.00 preferred stock since 1930. In the event of a general stock market rise Mr. Hewitt believed that the price of the Ohio Gauge Company's common stock would increase at a greater rate, percentagewise, than the stock market averages. Accordingly, he had bought several hundred shares and was advising his close friends and customers to do likewise.

Several months later Mr. Shea became curious about the company, looked up its financial record, and made some inquiries. Among the things he learned was that the Mammoth National Bank of New York owned a controlling interest in the company, which it had acquired in 1930 as collateral on a defaulted loan to a Cleveland brokerage firm.

The bank had been instrumental in getting several new directors elected and was trying to straighten out the company's affairs but was not meeting with much success.

The thought came to Mr. Shea that he could probably purchase the bank's interest at less than the current over-the-counter price of $2\frac{1}{8}$ because the bank would be glad to rid itself of the responsibility of managing an industrial company and because it could not hope to sell its shares without causing the price to break sharply. Once he had control Robert Shea thought he could persuade the preferred stockholders to consent to a recapitalization which would eliminate the accumulated arrears on the $8.00 preferred, thereby enhancing the prospects of paying dividends on the common stock. Such a move, he thought, would raise the price of the common stock substantially, enabling him to sell his holdings at a good profit.

Mr. Shea had learned that the Mammoth National Bank owned about 50,000 of a total of 116,000 outstanding shares of common stock. Since no other group owned as much as 10% of the stock, the Mammoth National Bank block was the controlling interest. Because of arrearages on the $8.00 preferred, each of the 22,940 preferred shares outstanding was entitled to four votes. The preferred stockholders had not organized, however, and Mr. Shea did not believe that they would endanger the success of his plan.

Mr. Shea thought that he could drive a hard bargain with the bank. He knew that no bank liked to find itself responsible for the management of an industrial company. He also believed that no one else had made an offer for the stock and that only a small number of shares could be absorbed by the market without causing a precipitate price decline. Under the circumstances, and in view of a current over-the-counter price of $2\frac{1}{8}$ and a 1932 low of 1, he thought that he would offer $1\frac{1}{4}$ for the stock, with the aim of settling for $1\frac{1}{2}$.

Mr. Shea discussed his plans with a few close friends and persuaded them to share in the venture. He himself intended to put $50,000 into the speculation, half of which amount he expected to borrow using the stock as collateral. William Hewitt was invited to participate but declined on the grounds that he lacked available funds.

The bank proved even more receptive than had been anticipated, and the 50,000 shares were obtained in July of 1933 at $1\frac{3}{8}$, or a total of $68,750. Shortly thereafter Mr. Shea was elected to the board of directors. Operation of the company was left in the hands of the existing

management while Mr. Shea concentrated on devising a plan of recapitalization. What he wanted was a plan that would eliminate the arrearages and modify the cumulative provisions of the preferred stock without materially diluting the common stockholders' equity.

Mr. Shea was aided by the fact that the Ohio Gauge Company had been incorporated in Massachusetts because of the comparatively liberal corporation laws of that state. Under Massachusetts' law a corporation could alter "the classes of its capital stock subsequently to be issued and their preferences and voting power, or make any other lawful amendment or alteration in its agreement of association or articles of organization by vote of two-thirds of each class of stock entitled to vote, or by a larger vote if the agreement of incorporation so required." The company's Agreement of Incorporation, in which were included the authorization and provisions of the preferred and common stocks, contained a similar clause. Mr. Shea wanted to take advantage of the law to create a new class or classes of preferred stock which would rank prior to the $8.00 preferred. The new stock would be offered to the $8.00 preferred stockholders for voluntary exchange. By making the recapitalization plan sufficiently attractive he hoped to get the required two-thirds of the $8.00 preferred stockholders to approve it. Once the plan was approved the dissenting stockholders would be under pressure to accept the exchange because the $8.00 preferred stock would then be subordinate to the new stock.

Mr. Shea discussed his plans with the company's counsel, the Cleveland firm of Frobisher, Fitzwilliam, and Frost. The firm was unwilling to commit itself on whether the issuance of stock having priority over the $8.00 preferred, as contemplated by Mr. Shea, would be sanctioned by the courts. Moreover, the firm indicated that they thought that his proposal was inadvisable even if it were legal. In view of their attitude, Mr. Shea reluctantly revised his plan. The recapitalization plan finally decided upon in October, 1933, after considerable discussion with the principal preferred and common stockholders, was as follows:

1. The following classes of stock would be created:
   a) $6.00 preferred stock with no par value which would be entitled to dividends when, as, and if declared by the Board of Directors at an annual rate of $6.00 a share. Such dividends would start in 1935 and would be cumulative only to the extent that they were earned in a given year. So long as any $8.00 preferred stock was outstanding, dividends (other than cumulative dividends) on the $6.00 and the $8.00 preferred stocks would not have preference over each other but

when, as, and if declared would be paid on a pro rata basis. The $6.00 stock would be callable in whole or in part at 105 plus accumulated dividends and would be entitled to $100 a share plus accumulated dividends pro rata with the rights of the $8.00 preferred stock on liquidation or dissolution. Holders of the $6.00 preferred stock would be entitled to two votes for each share whenever dividends in the amount of $6.00 a share had not been paid in the preceding calendar year.

b) $1.50 convertible preferred stock which would be subordinate in all respects to the $8.00 and the new $6.00 preferred and would be entitled to noncumulative dividends of $1.50 a share when, as, and if declared, in preference to the common stock. Each share of $1.50 preferred stock would be convertible at any time, prior to a date fixed for redemption and payment, into two shares of the common stock of the company as it might be at the time. The $1.50 convertible preferred stock would be callable at $32 a share (the amount of dividends which would have accumulated on the $8.00 preferred at the time the plan became effective) and would be entitled to $32 a share in preference to the common stock in the event of liquidation or dissolution. The stock would have no voting rights.

2. One share of the new $6.00 preferred and one share of the new $1.50 convertible preferred stock would be offered in exchange for each share of the $8.00 preferred stock and accumulated arrearages.

Having arrived at a plan, Mr. Shea next set about winning the consent of the 900 preferred stockholders and the principal common stockholders. The $8.00 preferred stock had been issued in 1923, with Sutcliffe and Company acting as sole underwriter. Sutcliffe and Company had lost interest in the company since the underwriting, and the firm was no longer represented on the board of directors and did not maintain a market for the issue. Nevertheless, Sutcliffe and Company was asked to help contact the stockholders, and it consented to speak to all of its customers who held the $8.00 preferred. However, the firm did not act as vigorously as Mr. Shea would have liked. William Hewitt was active, but it was largely on his own initiative and without encouragement from his employers. Mr. Shea also enlisted the assistance of a Cleveland securities firm, Forbes, Knox and Company. James Stuart, a trader and salesman in the latter firm, was especially active in Mr. Shea's behalf. Forbes, Knox and Company was able to pick up a substantial number of trading commissions by persuading doubtful stockholders to sell their shares and then reselling them to the firm's customers. Mr. Shea and his associates were also active, taking time off from their work to visit and correspond with individual stockholders.

In speaking with the preferred stockholders Mr. Shea emphasized the fact that there was little prospect of ever being able to pay in full the accumulated arrearages on the $8.00 preferred, thereby opening the way for resumption of common stock dividends. So long as this unfavorable prospect existed, he stated, management would have no incentive for paying anything on the preferred stock and would retain all earnings in the business. On the other hand, if the proposed plan were to go through, he promised that management would pay whatever dividends were earned on the preferred so as to leave the way open for resumption of common stock dividends at the first opportunity.

In his talks with the principal common stockholders Mr. Shea pointed out the advantages to them of eliminating the arrears and modifying the cumulative provisions of the preferred stock. He also emphasized the dangers inherent in the possibility of organized action by the preferred stockholders, especially in view of the $8.00 preferred stock's four-for-one voting power. As a result of the combined efforts of Mr. Shea, his associates, and the two securities firms, holders of 95% of the preferred stock and more than the required two-thirds of the common stockholders agreed to the recapitalization plan at a special stockholders' meeting in March, 1934.

While Mr. Shea had been working on the recapitalization plan, word of his activities had gotten around and the price of the common stock had gone to 6. No significant increase in price had occurred, however, after the plan had been officially accepted and put into effect (see Exhibit 1 [p. 270]). There was little interest in the stock, and its market remained "thin," with only a few hundred shares being traded each week. Mr. Shea and his associates realized that they would be unable to sell their shares without causing a ruinous price break. As a result, they were forced to hold their stock for the time being.

Profits were earned in 1935 and subsequent years. (See Exhibit 2.) True to Mr. Shea's promise to the preferred stockholders, 60% of the 1935 earnings were paid out as dividends, amounting to $3.00 a share on the $8.00 preferred and $2.25 a share on the $6.00 preferred. The regular $6.00 dividend, plus arrearages accumulated in 1935, was paid the following year and every year thereafter except in 1938, when earnings amounted to less than $0.004 a share on the $6.00 preferred, and dividends were omitted. Dividends were not paid on the $1.50 convertible preferred, which had no cumulative provisions of any sort until 1940, even though earnings had been available for such payment in

prior years. Starting with 1940 the regular $1.50 dividend was paid each year. Dividend payments were resumed on the common stock in 1940 also. Cash payments on the latter were as follows:

1940	$0.50 a share
1941	1.00 a share
1942	1.00 a share
1943	0.50 a share
1944	0.25 a share
1945	0.60 a share

In addition, 5% stock dividends were paid in both 1944 and 1945.

It was apparent to Mr. Shea and his associates when they decided in 1934 to continue holding their stock that they would have to strengthen the company's management in order to safeguard their investment. The management had never been outstanding, and the fierce competition characteristic of the depression had emphasized its shortcomings. Moreover, the company's plant and equipment were outmoded. For a number of years prior to 1930 the controlling stockholders, in order to conserve money for the payment of dividends, had prevented management from spending sufficient money on buildings and machinery. These stockholders had pledged their shares as collateral to finance personal speculations and a substantial price decline would, and in 1930 did, wipe them out. By continuing to pay dividends they had hoped to keep the price of the common stock from falling. As a result of its outmoded equipment, the company's production costs were relatively high. The sales organization also compared unfavorably with its competitors, chiefly because its best men had left in 1929 when drastic salary cuts were resorted to as a means of conserving cash.

Mr. Shea had thought that he would be able to straighten out the company's affairs in his spare time. Establishing the company on a sound operating basis, he had hoped, would raise the price and broaden the market for its common stock. Management by remote control proved unfeasible, however. By 1936 it had become apparent that rehabilitation of the company was going to be a long-run, full-time job. At the same time that Mr. Shea was coming to this realization, he was becoming dissatisfied with his position at National Shares, Inc. The latter's president had died in 1935 and Mr. Shea found himself out of sympathy with his successor's personality and policies. For these reasons, Mr. Shea, in 1936, decided to resign his Wall Street position to become president of Ohio Gauge Company. The latter position paid an annual salary of $35,000, almost twice what Mr. Shea had received from National Shares, Inc.

Mr. Shea soon learned that he had tackled a difficult job. The company was the principal employer in the town of Springdale, and the townspeople felt that they had a vested interest in the company's affairs. Mr. Shea found that it would not be politic to discharge a number of men whom he would have liked to replace. Instead, he had to devise new titles and to reallocate duties so as to create an organization with which he could be satisfied. Mr. Shea also encountered a great deal of difficulty in finding the right men for his organization. Mistakes were made and turnover of executive personnel was high. Nevertheless, some progress was achieved in the direction of improving sales and production and in replacing outworn and outmoded machinery. One of the steps taken shortly after Mr. Shea became president was to engage a New York law firm as counsel in place of Frobisher, Fitzwilliam, and Frost.

Following the 1934 recapitalization about half of the dissenting $8.00 preferred stockholders converted their shares. The remaining stockholders continued to hold out in expectation that the arrearages would eventually be paid in full so as to open the way for resumption of common stock dividends. Mr. Shea was determined not to pay the arrearages, however, because he felt that this small group was trying to profit at the expense of the other stockholders. Passage of the undistributed profits tax in 1936, however, enabled the company to effect a substantial tax saving by paying the accumulated dividends, so that Mr. Shea reluctantly agreed to do so. The shares still outstanding were called at the redemption price of $110 a share shortly thereafter.

By 1936 financial pressure on the company had slackened. At the time, the $6.00 and $1.50 preferred stocks were being quoted over the counter at a fraction of their call price (see Exhibit 1). Mr. Shea was of the opinion that it would be to the advantage of the common stockholders to purchase as much of the $6.00 preferred stock at current prices as the company could afford. Mr. Shea called James Stuart, whose work in winning consent to the 1934 recapitalization had impressed him favorably, and asked him to buy as much of the $6.00 preferred stock for the company's account as could be obtained at current prices. It was found, however, that only a relatively small number of shares could be obtained at quoted prices. The majority of the holders had owned the $8.00 preferred, for which they had paid a good price, and they were not interested in selling at a discount. In all, less than 1,000 shares of $6.00 preferred had been purchased up to the recession of late 1937, at which time Mr. Shea decided to discontinue the company's stock purchases in order to conserve cash.

From time to time, shares of the $1.50 preferred were converted. These conversions were usually connected with arbitrage transactions. As a rule, the price of the $1.50 preferred was twice the price of the common stock. From time to time, however, the price would fall below the 2:1 ratio. At such times some dealers would seek to make a profit by buying the preferred, converting it into common stock, and reselling the latter. Over 9,000 shares of the $1.50 preferred were converted in the period from 1934 to 1943.

In the fall of 1937, when security prices were reaching post-depression highs, Ohio Gauge common stock was quoted at 16½. The market for the stock remained thin, however, with weekly sales averaging 500 shares. When security prices fell in the latter part of the year average weekly sales rose to about 1,600 shares and the price was forced down to 4, a far greater percentage drop than was characteristic of the market as a whole.

In 1939 several European governments sent missions to the United States for the purpose of purchasing a variety of products, including gauges, to be used in preparing for the war which seemed imminent. Mr. Shea actively bid for such orders and was successful in obtaining a number of contracts. When war did break out in Europe, Mr. Shea anticipated that the United States would become involved eventually and that, in his words, a "bull market" in machine tools would follow. Accordingly, orders were placed for new machinery and the organization was geared for large-scale expansion.

When the United States embarked on a major defense program in 1940, Mr. Shea concentrated on obtaining government contracts. He soon succeeded in getting on favorable terms with the officials responsible for placing orders, and he co-operated with them fully in expediting production. In many instances he proceeded to make commitments for materials and for new equipment on the strength of verbal agreements made many months before written contracts were received. Due to Mr. Shea's efforts the company was well ahead of its competitors in percentage sales increase during the war. Symbolical of its leadership is the fact that it was among the first to win the Army–Navy "E."

Financing a greatly increased volume of business strained the company's financial resources. In November, 1940, an Emergency Plant Facilities contract was entered into whereby the company undertook to build and equip a new micrometer plant, for which the government was to reimburse it to the extent of 85% of cost. Total cost amounted to

$875,000 and was financed by a bank loan until reimbursement was received. In 1942 a contract was signed whereby the company was authorized to purchase up to $1,000,000 of equipment as agent for the Defense Plant Corporation. Payment was made by the Defense Plant Corporation direct to the seller. Some $900,000 of equipment was purchased under this contract, on which the company paid an annual rental of 12% of cost. At the end of the war, management expected to purchase the micrometer plant, and such of the equipment acquired under the Defense Plant Corporation contract as it could use, at about one-third of original cost. The company also purchased $1,060,000 of equipment on Certificates of Necessity from 1940 to September, 1945. These, in accordance with Treasury Department regulations, were amortized at an annual rate of 20%, and the unamortized portions were fully amortized on September 30, 1945, in accordance with the President's Proclamation of September 29, 1945.

Toward the end of 1941, bank loans, exclusive of loans for the construction of the micrometer plant, totaled $550,000 and Mr. Shea was greatly concerned about the likelihood that the growing volume of business would necessitate even greater borrowing. In 1942, however, advances totaling about $2,000,000 were received from the government and the bank loans were liquidated. Another unlooked for source of cash was accrued taxes. From 1942 through 1944 taxes payable ranged from about $1,500,000 to about $3,400,000.

When it became apparent to Mr. Shea in 1943 that the war years would be highly profitable and that the company would be in possession of cash in excess of its operating needs, he decided that the time had come to think seriously about eliminating the preferred stock. Under prewar conditions payment of preferred dividends had left little or no earnings for the common stock. Moreover, since the $6.00 preferred dividends were cumulative only to the extent earned, and since management did not wish to pay unearned dividends on the preferred stock, it had to wait until the end of each year before declaring any dividends on the common stock. Mr. Shea believed that placing the common stock on a quarterly dividend basis would enhance its appeal to investors.

The $1.50 convertible preferred was currently being quoted at around 14 and the $6.00 preferred at around 53. Mr. Shea decided that the company should resume the practice of buying its preferred stock on the open market, with a view toward acquiring as many shares as possible of the two issues.

In order to raise additional funds for this purpose it was decided to

take advantage of wartime increases in industrial property values to sell several small branch plants which had proved uneconomical. About $250,000 was realized from these sales. Another $50,000 was raised through the sales of the company's Cleveland warehouse, which had been carried on its books at a value, after depreciation, of $400,000. The loss on the sale was deductible for tax purposes. The space occupied by the company was subsequently leased from the new owner at a rental far below the previous annual charges.

Early in 1943, Mr. Shea instructed James Stuart, who had left the employ of Forbes, Knox and Company to accept a partnership in the Cleveland brokerage and investment banking firm of Willing, Smith & Westerly, to buy as many shares of the $1.50 and $6.00 preferred stock as could be obtained without materially influencing the price. Mr. Shea was willing to pay up to $16 a share for the $1.50 issue and up to $60 a share for the $6.00 preferred. These amounts were subsequently raised as the over-the-counter price of the stock increased (see Exhibit 1). It was found, however, that only a relatively small number of shares could be purchased at the prices at which the stocks were being quoted over the counter. In order to encourage selling, Mr. Stuart prepared a schedule of selected preferred stocks which had higher yields than the Ohio Gauge shares. Willing, Smith & Westerly sent this schedule to a list of stockholders obtained from the company's registry records, hoping that a large number would be persuaded to sell their Ohio Gauge shares and to buy the issues recommended in the schedule. The maneuver did not prove effective, however. In all, less than 3,500 shares of $6.00 preferred and 2,700 shares of $1.50 preferred were purchased between January, 1943, and June, 1945. In the latter month it was decided to ask for tenders from the $6.00 preferred stockholders. At the time, the stock was being quoted at about $82 a share. The stockholders' response proved disappointing, however. Only a few hundred shares were offered at less than 90, the maximum which Mr. Shea was willing to pay, and only a few hundred more were offered at less than the call price of 105.

After V–J Day, in August, 1945, Mr. Shea decided to use the funds accumulated during the war to call half the 16,000 shares of $6.00 preferred stock still held by the public. Redemption of the shares was voted by the directors and notice sent to the holders, late in August. In September of 1945 the price of the common stock, which had long been quoted at about the value of its net working capital, began to increase

and by October had reached a high of 20 (see Exhibit 1). Mr. Shea saw in this increase an opportunity to eliminate the $1.50 preferred without cash expenditure by calling the issue and thereby forcing conversion. He was concerned, however, by the possibility that the common stock might fall between the time the directors voted to redeem the $1.50 preferred and the redemption date. In order to minimize such risk it was decided to give only 15 days' notice of redemption. Before the redemption was voted, a questionnaire was sent to the shareholders informing them that the company was contemplating calling the issue and asking them whether they would convert their stock on receiving notice of such redemption. The principal purpose of the questionnaire was to get the stockholders to make their decision beforehand, so that they would act quickly after receiving their notice. Replies were received from about two-thirds of the stockholders, an unusually large response. Virtually all indicated that they would convert their shares in the event the issue was called. The redemption was voted and notice sent to the stockholders on November 15, 1945. At the same meeting the directors declared a $0.60 per share dividend on the common stock payable to stockholders of record on November 30, the last day on which the $1.50 preferred could be converted. With the exception of a few stockholders who failed to present their shares either for redemption or conversion and a few who evidently didn't understand much about securities, all the $1.50 preferred stockholders converted their shares prior to the November 30 deadline.

Mr. Shea next turned his attention to the task of eliminating the remainder of the $6.00 preferred. During the war he had several times discussed with his friend William Hewitt, who was now a partner in Sutcliffe and Company, the possibility of issuing common stock as a means of providing funds for redeeming the preferred. Now that the price of the common stock had passed 20 he felt that it was time to give serious consideration to such a step. While on a business trip to New York late in November, Mr. Shea called on Mr. Hewitt and asked him whether he had been serious when he had last spoken about underwriting an issue of the Ohio Gauge Company common stock. Mr. Hewitt replied that he certainly had been and that this looked like a good time to do it. Mr. Shea then asked if there would be "room" in the underwriting syndicate for Willing, Smith & Westerly and was assured that there would be.

One of his aims in the event a public issue was decided upon, Mr.

Shea informed Mr. Hewitt, would be to broaden the market for the company's stock. Mr. Hewitt replied that his firm, and the members of the selling group to be formed, could make an effort to distribute the issue as widely as possible. Some selling agreements, he informed Mr. Shea, provided that the participants would endeavor not to sell or allot to any one customer more than a given number of shares. Wide distribution, Mr. Hewitt added, not only would broaden the market for the issue but would also minimize the risk that some group might purchase enough stock to challenge Mr. Shea's control of the company.

Mr. Hewitt also suggested that the issue be listed on the New York Stock Exchange as a means of adding to the company's prestige and broadening the market for its stock. He pointed out that many investors and investment counselors favored listed securities because it was believed that they could be sold more readily, in an emergency, than could unlisted securities.

Mr. Shea questioned the value of listing on the exchange, however. People, he said, didn't buy securities because they were listed on the Stock Exchange; they bought them because they thought that they would go up in price. Many unlisted securities, he pointed out, had a high turnover, while a number of listed securities were traded only infrequently. Moreover, listing on the exchange would place the issue under the Securities Exchange Act of 1934. This act, Mr. Shea reminded Mr. Hewitt, required additional periodic reports which were not called for by the Securities Act of 1933. Mr. Shea called especial attention to Section 16a of the 1934 act which required holders of more than 10% of any listed security and officers and directors of issuers of a listed security to report any changes in their holdings.

The price at which the issue would be sold to the public would be determined by the price at which the common stock was selling at the time of filing the price amendment to the registration statement required by the Securities and Exchange Commission. This amendment would be filed within 24 hours before the registration of the issue was scheduled to become effective.

While discussing the underwriting fee that his firm would receive, Mr. Hewitt said that the average fee for comparable issues floated during the past few months would be acceptable. This average amounted to about 8% of the selling price. Mr. Shea argued that the fee should be less than average, however, because of their close relationship. He expressed the fear that other stockholders might claim that the com-

pany could have gotten a better deal by shopping around and that a smaller than average fee would forestall any such accusations. After some discussion Mr. Hewitt agreed, subject to the approval of his partners, to accede to his friend's wishes on this point.

Mr. Hewitt recommended that the preparation of the registration statement required by the Securities and Exchange Commission be started immediately so as to enable the company to offer the issue as soon as possible, thereby minimizing the risk of a decline in the common stock's price before the offering date. The registration statement would require, among other information, recent audited statements. Mr. Hewitt suggested that the company's public accountants be engaged to prepare statements as of November 30, 1945. Mr. Shea, however, indicated that he would prefer to wait for the regular year-end audit. December, he anticipated, would be a profitable month, and he would like to have it included in the prospectus. Moreover, he said that he had a hunch that the market was going up during the next few months, so that it would be to the company's advantage to wait.

At the conclusion of his talk with Mr. Hewitt, Mr. Shea said that he would like to give further thought to the matter. He had some doubts as to whether $22 a share, at which the common stock was currently being quoted, was a fair price. He was also undecided about whether to list on the Stock Exchange and whether to wait for the regular year-end audit.

Exhibit 1

THE OHIO GAUGE COMPANY

Over-the-Counter Stock Prices (Bid)

	Common		$1.50 Convertible Preferred		$6.00 Preferred	
	High	Low	High	Low	High	Low
1928	16	$9\frac{1}{4}$	..	..	..	..
1929	$25\frac{1}{2}$	12	..	..	..	..
1930	20	6	..	..	..	..
1931	6	$1\frac{1}{4}$	..	..	..	..
1932	$2\frac{3}{8}$	1	..	..	..	..
1933	6	$1\frac{1}{2}$	..	..	..	..
1934	$6\frac{5}{8}$	5	..	..	..	..
1935	$10\frac{1}{2}$	$4\frac{1}{2}$	$21\frac{1}{2}$	$9\frac{1}{2}$	50	29
1936	$10\frac{1}{4}$	$6\frac{3}{8}$	$20\frac{3}{4}$	14	54	44
1937	$16\frac{1}{2}$	4	34	8	78	26
1938	$8\frac{3}{8}$	$4\frac{1}{4}$	14	7	53	28
1939	$11\frac{1}{4}$	$4\frac{1}{2}$	22	9	57	32
1940	$10\frac{5}{8}$	$6\frac{3}{4}$	20	14	68	48
1941	$10\frac{1}{2}$	$6\frac{1}{2}$	21	15	69	50
1942	$7\frac{1}{2}$	$5\frac{1}{8}$	$16\frac{1}{2}$	13	$58\frac{1}{2}$	51
1943	10	$5\frac{1}{2}$	18	13	57	51
1944	$11\frac{1}{8}$	$6\frac{5}{8}$	23	15	78	55
1945*	24	$10\frac{3}{4}$	40	22	102	71

* To November 30

Exhibit 2

OHIO GAUGE COMPANY

Income Data

(Dollar figures in thousands)

Calendar Year	*Gross Sales—Less Discounts, Returns, and Allowances and Renegotiation Provision*	*Cost of Sales and Selling and Administrative Expenses*	*Provision for Depreciation and Amortization*	*Net Income before Taxes on Income and Extraordinary Deductions*	*Provision for Taxes on Income*	*Extraordinary Deductions*	*Net Income*
1928	$ 3,027						$410
1929	3,439						502
1930	2,182						124
1931	1,330						68[d]
1932	883			Data Not Available			162[d]
1933	1,240						12[d]
1934	1,747						77
1935	2,555						89
1936	3,223	$ 2,735	$133	$ 355	$ 23	$ 14*	318
1937	4,198	3,347	122	683	69	...	614
1938	2,563	2,362	136	27	1	26*	†
1939	3,464	2,977	138	327	68	...	259
1940	5,094	3,906	217	883	402	...	481
1941	10,232	6,904	368	2,769	1,854	311‡	604
1942	16,458	12,288	432	3,557	2,719	234‡	604
1943	17,361	13,593	483	2,989	2,271	234‡	484
1944	13,827	10,862	534	2,315	1,752	144‡	419
1945§	11,967	9,857	368	1,574	1,205	...	369

* Flood expense.
† Net income in 1938 was $71.
‡ Provision for contingencies and postwar adjustments.
§ As estimated in November.
[d] Deficit.

Exhibit 3

OHIO GAUGE COMPANY

Balance Sheets

(Dollar figures in thousands)

ASSETS

	Dec. 31 1938	Dec. 31 1941	Dec. 31 1944	Sept. 30 1945
Current assets:				
Cash	$ 93	$ 15	$1,904	$1,658
U.S. excess profits tax refund bonds—due 1/1/46	....	....	....	288
Accounts receivable, net	265	1,454	1,667	1,094
Inventories	1,215	2,541	1,467	1,366
Claim for refund of prior year's taxes	....	....	....	231
Total current assets	$1,573	$4,153	$5,038	$4,637
Other assets:				
Treasury stock:				
$6.00 preferred	....	....	179	....
$1.50 preferred	....	....	34	....
Net property, plant, and equipment	2,430	2,515	2,071	1,830
Emergency plant facilities	....	$ 849	$ 884	....
Less: Reserve for amortization	....	109	636	....
Balance	....	$ 740	$ 248	....
Postwar refunds of excess profits taxes—estimated	....	....	394	....
Other assets	26	42	308	94
Total assets	$4,029	$7,450	$8,272	$6,561
LIABILITIES AND CAPITAL				
Liabilities:				
Current liabilities:				
Notes payable to banks—emergency plant facilities	....	....	$ 149	....
Notes payable to banks	$ 239	$ 687	....	....
Accounts payable	68	522	299	$ 244
Accrued expenses	....	....	87	99
Accrued taxes	16	159	179	161
Advance from U.S. government on contracts	....	....	270	....
Provision for federal income and excess profits taxes	83	1,230	1,419	1,447
Total current liabilities	$ 406	$2,598	$2,403	$1,951
Other liabilities:				
Notes payable to banks—emergency plant facilities	....	661	175	....
Reserve for postwar contingencies and adjustments	....	90	810	810
Total liabilities	$ 406	$3,349	$3,388	$2,760
Capital:				
Capital stock†	$2,931	$2,931	$2,918	$1,741
Surplus	692	1,170	1,966	2,060
Total capital	$3,623	$4,101	$4,884	$3,801
Total liabilities and capital	$4,029	$7,450	$8,272	$6,561

* Not audited.

† Number of shares:

$6.00 preferred—no par	20,700	20,700	20,296	8,000
$1.50 preferred—no par	16,074	12,817	12,216	.....
Common stock—no par[1]	125,985	131,104	138,341	166,068

[1] Common stock was sold to officers and employees under a stock-purchase plan.

La France Industries

The parts of this case are:

1. Summary of corporate history.
2. Description of the proposed plan of reorganization, excerpted from SEC Reorganization Release No. 16, dated September 1, 1939.
3. SEC findings as to the fairness and feasibility of the plan, quoted (without footnotes) from the SEC release.

PART 1

On July 11, 1939, the District Court of the United States for the Eastern District of Pennsylvania referred to the Securities and Exchange Commission a proposed plan of reorganization for La France Industries and its wholly owned subsidiary, the Pendleton Manufacturing Company. The plan, which had been approved informally by protective committees representing the mortgage bondholders and other creditors, had been submitted by the debtor. Under the provisions of Chapter X of the Bankruptcy Act, it was the duty of the Securities and Exchange Commission to render an opinion on the fairness and feasibility of the plan.

In normal years the two companies manufactured a substantial part of the upholstery fabrics produced in the United States. They also manufactured rugs and miscellaneous textile products. The weaving of these fabrics was done in a plant owned by the Pendleton Manufacturing Company at La France, South Carolina, and the dyeing and finishing processes were carried out in the plants of La France Industries in the neighborhood of Philadelphia. A Canadian subsidiary operated a plant at Woodstock, Ontario.

The financial difficulties of the companies became acute in 1936; La France Industries filed a voluntary petition in bankruptcy in July of that year, and the Pendleton Manufacturing Company filed a sim-

ilar petition in September. The court appointed as trustee for both companies a man who had had no previous connection with either company. By 1939 it was seen that the trusteeship had been more than ordinarily efficient in instituting economies and holding the trade position of the companies during a period of good volume of business for firms in the industry.

During the progress of the trusteeship, certain claims were determined by suit or by stipulation. Thus by July, 1939, the obligations that were to be dealt with in the reorganization were definitely known. These obligations, exclusive of those created by the trustee, are shown in Exhibit 1 (p. 274).

Profit and loss statements for the combined companies for the years 1933 through 1938 are shown in Exhibit 3 (p. 276).

A description of the plan of reorganization is quoted below. The proposal has been tabulated in Exhibit 2 (p. 275). In Exhibit 4 is presented a pro forma balance sheet giving effect to the proposed plan (p. 277).

PART 2

The plan provides for the transfer of all the assets of Pendleton to La France Industries and for the dissolution of Pendleton. The Canadian subsidiary will continue as a wholly owned subsidiary of the reorganized company.

The securities to be issued under the proposed plan of reorganization are:

1st mortgage RFC loan (5%)	$600,000
2nd mortgage 4% bonds	731,250
Certificates of indebtedness	173,735
6% preferred stock	877,500
Common stock	194,168 shares

A. DESCRIPTION OF THE NEW SECURITIES

The first mortgage obligation will be issued to the Reconstruction Finance Corporation in the principal amount of $600,000. The loan is to bear interest at 5% and is to mature in 10 years, with amortization of not less than $60,000 annually. If earnings [after interest and taxes but before depreciation] exceed $120,000 annually, then one-half of such earnings are to be applied to amortization.

This loan is to be secured by: a first mortgage upon all of the fixed assets of the reorganized company; a pledge of all of the common stock

of the Canadian subsidiary; an assignment of certain insurance policies on the life of Bernard Davis, in the face amount of $500,000; and an assignment of the net proceeds of any recovery, to the extent of the unpaid balance of this loan, from [a suit against certain former directors of the company].

The new second mortgage bonds are to bear interest at 4%, mature in 15 years, and be secured by a lien, junior to that of the RFC, on the fixed assets and the proceeds of the lawsuit. The bonds are also [to be] secured by a first lien on $1,000,000 of insurance on the life of Davis, which now secures the present first mortgage bonds; this is insurance other than that which will secure the RFC first mortgage. The stock of the Canadian subsidiary is expressly excluded from the lien of this mortgage.

While the RFC loan is outstanding, the second mortgage bondholders cannot foreclose their lien on the fixed assets in the event of any default, regardless of its nature. This prohibition applies whether or not the RFC loan is in default. Sinking fund payments are to become operative only after the complete repayment of the RFC loan. Such payments on the bonds are to be $60,000 annually or one-half of net profits before depreciation, whichever is greater, except that the board of directors may limit the maximum to $60,000. [Net profits are defined as net earnings after interest and taxes but before depreciation.] The sinking fund may be used to purchase bonds at a price not exceeding 102 or to retire them by lot at 102. The bonds are convertible into

Exhibit 1

LA FRANCE INDUSTRIES AND PENDLETON MANUFACTURING COMPANY

OBLIGATIONS AS DETERMINED FOR PROPOSED REORGANIZATION
(Dollar figures in thousands)

Taxes accrued before trusteeship		$ 24
Mortgage of La France Industries on one plant:		
Principal	$ 60	
Accrued interest	2	62
First mortgage bonds of La France Industries:		
Principal	$1,463	
Accrued interest	292	1,755
Unsecured claims:		
La France Industries	$ 246	
Pendleton Manufacturing Company	116	362
Total claims		$2,203
Common stock of La France Industries	164,918 shares	

Source: SEC Corporate Reorganization Release No. 16, September 1, 1939.

Exhibit 2

LA FRANCE INDUSTRIES AND PENDLETON MANUFACTURING COMPANY

EXCHANGES PROPOSED UNDER PLAN OF REORGANIZATION

Existing Claims		Securities to Be Issued				
Description	Amount Outstanding	First Mtg. Bonds $600,000*	Sec. Mtg. Bonds	Certifs. of Indebtedness	Preferred Stock (Shares)	Common Stock (Shares)
First mortgage bonds	$1,462,500†					
Unpaid interest to 10/1/39	292,500					
	$1,755,000	......	$731,250	......	8,775	29,250
Unsecured creditors	347,470‡	......	......	$173,735 (plus cash of $173,735)	....	......
Common stock	164,918 shs.	......	......	......	....	164,918
		$600,000	$731,250	$173,735	8,775	194,168

* New money from RFC
† The $60,000 mortgage on the Prudential plant of La France Industries, together with accrued interest, was to be paid in cash in full under the plan.
‡ Exclusive of $14,795 of small or preferred claims to be paid in cash in full.
Source: SEC Corporate Reorganization Release No. 16, September 1, 1939.

Exhibit 3

LA FRANCE INDUSTRIES AND PENDLETON MANUFACTURING COMPANY

CONSOLIDATED PROFIT AND LOSS STATEMENT, YEARS ENDED DECEMBER 31, 1933–1938

(Dollar figures in thousands)

	1933	*1934*	*1935*	*1936*	*1937*	*1938*
Net sales	$3,799	$3,443	$3,732	$4,791	$5,351	$4,737
Cost of sales, adjusted*	2,610	2,701	2,979	3,675	4,270	3,608
Selling expenses	493	460	495	581	671	699
Administrative expenses	227	249	290	293	263	283
Depreciation	210	211	207	192	181	182
Net operating profit	$ 259	$ 178[d]	$ 239[d]	$ 50	$ 34[d]	$ 35[d]
Dividends received from subsidiary	$ 50	$ 208	$ 122	$ 77	$ 59	$ 74
Other income	58	45	50	57	70	57
Nonrecurring income	95	21	....	....	....	....
Nonrecurring expenses†	85	98	110	96	100	40
Profit before charges	$ 377	$ 2[d]	$ 177[d]	$ 88	$ 5[d]	$ 56
Bond interest	$ 93	$ 89	$ 88	$ 88	$ 88	$ 88
Other financial expenses	80	73	80	85	75	41
Net profit	$ 204	$ 164[d]	$ 345[d]	$ 85[d]	$ 168[d]	$ 73[d]
Undistributed income of Canadian subsidiary	$ 4[d]	$ 141[d]	$ 61[d]	$ 7	$ 70	$ 23[d]

* Excludes nonrecurring expenses.
† Includes nonrecurring costs of operation, and reorganization expenses.
[d] Deficit.
Source: SEC Corporate Reorganization Release No. 16, September 1, 1939.

Exhibit 4

LA FRANCE INDUSTRIES

PRO FORMA BALANCE SHEET, GIVING EFFECT TO THE MERGER WITH PENDLETON MANUFACTURING COMPANY AND TO THE PROPOSED REORGANIZATION, AS OF MARCH 31, 1939

(Dollar figures in thousands)

ASSETS

Cash	$ 209
Accounts receivable	561
Inventories	1,241
Current assets	$2,011
Cash value of life insurance	110
Prepaid and deferred charges	105
Stock of Canadian subsidiary	303*
Land and plant, less depreciation	2,045†
	$4,574

LIABILITIES

Accounts payable, etc.	$ 254‡
RFC loan due within one year	60
Current liabilities	$ 314
Balance of RFC loan	540
Second mortgage bonds	731
Certificates of indebtedness	174
6% preferred stock (par $100)	878
Common stock (no par; 194,168 shares)	874
Surplus	1,063
	$4,574

* Valuation stipulated by parties to the reorganization.
† An estimate of reproduction cost new, less depreciation.
‡ Trustees' current liabilities and accrued taxes assumed by the new company.
Source: Moody's *Industrials, 1939*.

preferred stock at the rate of one share for each $100 principal amount of bonds.

The certificates of indebtedness are unsecured, have no fixed maturity, and are to be paid only out of earnings. The following amounts are to be set aside for that purpose: (1) so long as the RFC loan is outstanding, 25% of the amount by which net earnings (after interest and taxes but before depreciation) exceed $120,000; (2) after retirement of the RFC loan, [at least] 50% of such net earnings but no more than the amount by which such earnings exceed $60,000. Interest of 4% on these certificates is to run only from the date of repayment of the RFC loan.

The new preferred stock is to have a par value of $100. Cumulative dividends at the rate of 6% are provided. By the terms of the RFC loan, however, no dividends can be paid during the life of the loan,

so that by the terms of the plan, dividends will . . . accumulate during that period. [The stock will be callable after payment of the RFC loan at 105 and accrued dividends.]

The common stock is to receive no dividends until the RFC loan, certificates of indebtedness, and accumulated preferred stock dividends have been paid in full. Thereafter, only 10% of the net income otherwise available for dividends on common stock may be paid as a dividend until the new [second mortgage] bonds are retired. After the bonds are retired, 25% of such net income may be paid as common stock dividends until the preferred stock is retired.

Voting control is to continue to reside with the common stockholders, but, under the terms of the RFC loan, management must be satisfactory to it while any part of the loan remains unpaid. The preferred stockholders as a class will be entitled to elect two of seven directors. While the RFC loan is outstanding, [second mortgage] bondholders will have the right to elect a majority of the directors if there is a "default in the payment of any interest on new bonds." After the RFC loan is repaid, preferred stockholders will be entitled as a class to elect a majority of the board if there is a default in payment of interest, sinking fund requirements or principal on the bonds, or a default in six consecutive quarterly dividends on the preferred stock.

B. ALLOCATION OF THE NEW SECURITIES

For each $1,000 first mortgage bond and $200 of accumulated interest thereon to October 1, 1939, there will be issued $500 principal amount of new second mortgage bonds and $500 of new preferred stock in payment of principal and $100 of new preferred stock, representing half of the interest accumulations. All of the new second mortgage bonds and new preferred stock will be issued in exchange for the outstanding bonds. The bondholders are also to receive common stock at the rate of 20 shares for each $1,000 old bond, receiving as a class 29,250 shares, or approximately 15% of the total common stock issue.

The $60,000 plant mortgage [with accrued interest] is to be paid in cash in full.

Merchandise creditors whose claims exceed $200 are to receive 50% of the amount of their claim in cash and the balance in certificates of indebtedness. Creditors with claims of $200 or less are to be paid in cash in full. [The current liabilities of the trustee and the accrued taxes are to be assumed by the new corporation.]

Common stockholders retain their present securities, which will constitute 85% of the total common stock to be outstanding upon consummation of the plan.

PART 3

A. FAIRNESS OF THE PROPOSED PLAN

The extent of the participation of any class of creditors or stockholders in a plan or reorganization is to be determined by the established principle that claims and interests shall be provided for in the order of their seniority and only to the extent that the value of the debtor's properties supports recognition of each class. If the effect of a plan is to divert values to stockholders at the expense of creditors, or stated differently, if it imposes sacrifices upon creditors without providing adequate compensation therefor, the plan fails to meet the statutory and judicial standard of "fairness."

1. The Treatment Accorded Bondholders

It is evident that the new bonds and preferred stock to be given the bondholders will not fully compensate them for their present claims, even if it be assumed that the full face amount of these new securities ultimately will be realized. Unless it can be shown that the proposed allocation of common stock to present bondholders makes up this deficiency at least, the plan must be condemned as unfair. Furthermore, the adequacy of the allocation of new securities to present senior creditors must be judged with due regard to the changes which the plan works upon their present status and contractual rights.

The sacrifices which bondholders are called upon to make, even on the assumption that the new senior securities ultimately will be paid at par, may be summarized as follows:

(1) The bondholders have a present claim for principal of \$1,462,500 and accumulated interest of \$292,500, an aggregate \$1,755,000. The face value of the new bonds and preferred stock totals \$1,608,750, designed to cover the principal and one-half of the back interest on the bonds. The bondholders' sacrifice of back interest will amount to \$146,250.

(2) The maturity of the bonds is being extended for 15 years following consummation of the plan.

(3) The bondholders' lien position will be subordinated as a result of the RFC first mortgage.

At present the bondholders have a first mortgage on the plants of La France Industries and as to other assets (except Pendleton's) are on a parity with unsecured creditors. After consummation of the plan they will have a second mortgage on all plants; as to other assets, although they will be on a parity with unsecured creditors, they will be subordinate to the RFC lien.

(4) As to half of the principal amount of their presently outstanding bonds, the bondholders are to receive only preferred stock, with a consequent change of status from creditor to stockholder.

(5) In addition to the fact that the new securities to be given to the bondholders are inferior to their present bonds, the interest and dividend return on the new securities which bondholders are receiving for principal amount of old bonds will be less, by $153,375, over the life of the bonds than the return to which they were entitled on the old principal amount.

(6) Dividends on the preferred stock will not be payable during the life of the RFC loan, so that as to actual dollar return, the bondholders during the life of the RFC loan can receive at best no more than 4% on the new second mortgage bonds, or $20 per $1,000 of old bonds as compared with the $60 to which they are now entitled.

All of these elements are important. Those which are not subject to precise measurement in terms of dollar value are nevertheless significant. It is therefore appropriate to analyze the available evidence relating to the value of the enterprise and of the new common stock, to determine whether the allocation of common stock to bondholders renders the plan fair.

2. Book Value of Assets

In a pro forma balance sheet annexed to the plan, the total value of the assets of the debtor and subsidiary debtor are $4,574,071.22 as of March 31, 1939. As against this there are current liabilities of the trustee of $247,781.36, which the reorganized company will have to meet. On the basis of these book values, the net assets of the reorganized enterprise would total $4,326,289.86. This book figure includes fixed assets at $2,044,805.71, a valuation founded upon an appraisal submitted to the court in 1936.

This appraisal, however, was based upon reproduction cost new less depreciation. It is well recognized that this method of valuation is not a proper guide to the value of a going concern for reorganization purposes in the absence of a showing that the assets may be employed in the conduct of the enterprise so as to yield a fair return, after depreciation, upon the values so assigned. The view generally accepted both by authorities in the field of finance and by the courts is that, for the purposes of reorganization, the reasonably prospective earnings of an enterprise constitute the proper standard of measurement of its value as a going concern.

3. Earnings of the Enterprise

In order to translate earnings into a valuation, it is customary to use the device of capitalizing earnings which may be reasonably anticipated. The rate of capitalization is determined in the light of the risks inherent in the venture and will reflect the rate of return which the investor might fairly require as compensation for an investment subject to such risks.

In such a calculation, it is also proper, however, to consider separately those asset items which do not contribute to the earnings of the enterprise as a whole and which, consequently, have independent value in themselves. Accordingly, it has been generally agreed in this proceeding that the investment of La France Industries in the Canadian subsidiary and the cash surrender value of the insurance on Mr. Davis' life should be valued separately.

The life insurance is shown by the balance sheet of La France to have a cash surrender value of approximately $110,000. The value of the stock interest in the Canadian subsidiary depends upon the earnings of that company.

a) The Canadian Subsidiary.—From 1933 to 1938, net profits of the Canadian subsidiary, after depreciation, averaged $73,381 annually. There is apparently little reason for anticipating any substantial change in the earnings of this company from those of the recent past; and, consequently, past profits would appear to provide a reasonable guide to its future earnings. Because of the relative stability of operations and this company's earnings record, it is reasonable to capitalize those earnings at a rate of 9%, thereby valuing the Canadian enterprise for present purposes at approximately $815,000.

b) *La France and Pendleton.*—The past earnings record and future prospects of La France and Pendleton are of primary importance in determining the value of their remaining assets, both current and fixed.

[In Table 1] historical earnings for the period 1933–1938 are shown as adjusted to eliminate charges which are not expected to recur in the future.

[Table 1]

NET PROFITS BEFORE INTEREST, DIVIDENDS FROM CANADIAN SUBSIDIARY, AND DEPRECIATION

	Unadjusted	*Adjusted for Non-recurring Items*	*Depreciation*
1933	$456,629	$412,209	$209,884
1934	(71,566)*	5,574	211,325
1935	(172,927)	(63,107)	207,251
1936	120,509	216,974	191,856
1937	42,290	142,261	180,607
1938	123,819	163,956	181,592
1933–1938 av.	83,125	146,311	197,086
1936–1938 av.	95,539	174,397	184,685

* ( ) = Loss.

It appears that, against actual average annual earnings before depreciation of $83,125 for the period 1933–1938, the indicated adjusted earnings are $146,311, or an increase of 76%. Similarly, for the period 1936–1938, the actual average annual earnings before depreciation are $95,539, whereas the adjusted earnings are $174,397, or an increase of 83%.

The results of the three years from 1936 to 1938 appear to provide the best basis upon which to judge future possibilities. Operations prior to 1936 were affected by many extraordinary factors. The period 1936–1938, on the other hand, although the period of the trusteeship, was not a period of unusual business activity or of depression for this company. The earning prospects for La France Industries and Pendleton are influenced by factors which in part make it reasonable to anticipate some improvement over recent profit figures, as adjusted by the elimination of nonrecurring charges. The weight of these factors is reviewed in the following:

(1) There is reason to believe that because the company has been in reorganization and has had limited working capital and credit, volume and profits have been curtailed to some extent. However, it is also clear that the trusteeship has been more

than ordinarily efficient in instituting substantial economies, maintaining the "esprit de corps," and helping to "hold a certain trade position." Consequently, while the termination of the proceedings and the improvement of the working capital position as a result of the RFC loan may aid earnings, only moderate improvement may be assumed merely by reason of these factors.

(2) There are undoubtedly some new types of products which the company could make on its present looms and for which a demand exists. However, there is no indication that these new lines would be likely to result in any substantial improvement in volume or profits.

Considerable testimony was adduced particularly on the subject of possible expansion into the automobile fabrics field. While it was alleged that contacts with large automobile manufacturers are necessary in order to enter this highly specialized phase of the textile business, it was also stated that the reorganized company would possess such contacts. However, neither the testimony nor the company's history gives reasonable assurance of the debtor's ability or intention to enter this field. More significantly, no estimate has been ventured as to what such business might mean in terms of additional volume or profits. Furthermore, there is uncertainty as to whether entry into this field would not be accompanied by curtailment of production or increased operating costs on present lines, or else by an expansion of inventories of such lines with a greater risk of inventory loss and an attendant need for additional financing. Consequently, no allowance for a major increase in profits from this possible type of expansion appears appropriate at this time.

(3) The company's principal activity, constituting about 80% of its business, is the manufacture of upholstery fabrics for sale to the furniture trade. The prospects for the sale of these products depend in large measure upon the volume of furniture manufacturing. This, in turn, is affected by residential construction. On the basis of the current estimates concerning this type of building activity, it appears reasonable to conclude that some improvement in this aspect of the business may be anticipated.

(4) The manufacture of rugs and allied products, which in 1938 accounted for 19% of total sales, is to some extent influenced by foreign competition, although perhaps less so recently as a result of a change in the nature of this line. If no change in the tariff situation is assumed, it appears reasonable to expect this phase of the business to contribute to total future operations in much the same fashion as before. There is nothing in the nature of, or future outlook for, this portion of the debtor's business which foreshadows any appreciable growth.

A consideration of the various elements which are likely to influence future earnings leads to the conclusion that it is reasonable to anticipate that annual profits of the reorganized company will exceed those which were reported by La France and Pendleton for the years 1936 to 1938. It is also reasonable to expect that annual earnings in the future may be in excess of the $175,000 figure representing the 1936–1938 average, after adjustment for nonrecurring items but before depreciation. There would not appear, however, to be any basis for expecting any radical increase over this figure.

4. Conclusions as to Fairness

The initial aspect of fairness to which the foregoing data are addressed is whether, assuming that the new bonds and preferred stock adequately compensate for bondholders' present claims for principal and one-half of accumulated interest, 15% of the common stock equity is fair compensation for the sacrifices which they are called upon to make. As we have observed above, there are, in addition to the definite loss of $146,250 of back interest and of approximately $150,000 representing reduced income on the new securities to be given to bondholders, other significant sacrifices not subject to precise monetary measurement.

If, for the moment, there is considered only the $146,250 loss of accumulated interest (and it is assumed that the purpose in allotting bondholders 15% of the common stock equity is to compensate them for this loss of accumulated interest), 15% of the common stock equity would have to have a value of $146,250, if this minimum standard of fairness is to be met. On that basis, the total value for all of the common stock of the new company would have to equal $975,000. That this standard is not met readily appears from the following analysis.

The new company will have claims senior to the common stock as follows:

RFC loan	$ 600,000
Second mortgage bonds	731,250
Certificates of indebtedness	173,735
6% preferred stock	877,500
	$2,382,485

If senior issues are to be adequately covered and sufficient value remain for the common stock so that the plan would fairly compensate the bondholders for their loss of $146,250 of accumulated interest by the allotment of 15% of the common stock, the value of the enterprise must consequently equal approximately $3,360,000 ($975,000 plus $2,382,485). If the independent value of $815,000 for the company's investment in the Canadian subsidiary and the $110,000 cash value of the life insurance are deducted, then there must be a going concern value of $2,435,000 for La France Industries and Pendleton alone.

Such a going concern value is tenable only to the extent that it is consistent with and represents a fair capitalization of reasonably prospective earnings of La France and Pendleton after depreciation. Because of the apparent risks involved in the operations of the American companies evidenced in part by their history of fluctuating income, 10% would seem to be a fair rate of capitalization. On the basis of this rate of capitalization, it would be necessary, in order to show a going concern value of $2,435,000, that reasonable prospective earnings, after depreciation, be approximately $243,000 annually for La France and Pendleton. The past earnings record of the American companies and the factors affecting future prospects do not support such an estimate.

As we have indicated, adjusted earnings *before depreciation* averaged approximately $175,000 from 1936 to 1938, and there is no reason to anticipate more than a moderate increase above this level. A proper depreciation charge would appear to exceed $65,000 annually, reducing the $175,000 figure to no more than $110,000 after depreciation.

Clearly it would require undue optimism to predict future annual earnings of $243,000 after depreciation. In order to reach this result, the maximum net earnings for the period 1936–1938 of $110,000 would have to be increased by approximately 120%.

It does not appear, therefore, that prospective earnings would support a going concern value for the American companies equal to $2,435,000. Consequently, [earnings] do not provide a basis for establishing a value of the total enterprise sufficiently high so that the 15% of the common stock to be given to the bondholders can be regarded as

adequate compensation for their loss of accumulated interest alone. On this basis alone, therefore, the plan must be considered unfair. Furthermore, this approach has given no consideration to the other significant sacrifices which bondholders will make under the proposed plan of reorganization.

Conversely, the earnings record and prospect for La France Industries and Pendleton raise a serious question as to the extent of any participation in the new company to be allotted to the present common stockholders. To demonstrate on an earnings basis value allocable to the present common stock sufficient to support its proposed participation in this plan, it would be necessary to show a substantial increase in gross earnings and a substantial reduction in depreciation from the level which the company has recently been charging. Therefore, in view of our previous discussion, it appears that the extent of participation by the old common stock which the present plan proposes is not supportable.

B. FEASIBILITY OF THE PROPOSED PLAN

The only fixed charges set up by the plan are those on the RFC loan and the second mortgage bonds. On the basis of past earnings and assuming continuation of past dividend income from the Canadian subsidiary, it appears that the company would be prepared to meet, with an adequate margin, the required interest and amortization on the RFC loan and the interest on the second mortgage bonds.

It should be noted, however, that the plan contains elements of unsoundness. Too large a proportion of senior securities is imposed upon the reorganized company. The new first mortgage, second mortgage bonds, certificates of indebtedness, and preferred stock represent total face value of $2,382,485. This constitutes about 55% even of the book value of the assets of the company (less current liabilities). The extent to which these senior issues will constitute the greater part of the company's total value is even larger if such value is based on earnings.

While this feature of the reorganized company's capital structure may not of itself brand the plan as unsound, it should be considered in connection with the further fact that under the plan additional claims prior to the common stock will accumulate in the form of unpaid dividends on the preferred stock. The plan provides that no dividends shall be payable on the preferred stock during the life of the RFC loan. At the same time, dividends will accumulate on this stock at the rate of 6% per annum. Even on the basis of a maximum estimate of anticipated

earnings ($300,000 per annum before depreciation for the entire enterprise, including dividends from the Canadian subsidiary), it appears unlikely that the RFC loan will be paid off in less than five years. Even if the loan were paid off in five years, there would necessarily be an accumulation of $30 per share at the end of that period on each of the 8,775 shares of preferred stock outstanding, or a total accumulation of $263,250.

The fact that the dividends on the preferred stock will not be paid during a period of years following reorganization, and that over this period large arrearages will accumulate, clearly indicates, we believe, that the contemplated plan is unsound. Moreover, eventual payment in cash of the accumulated dividends would appear open to question. Experience shows that in such situations removal of the burden of the arrearages through some form of recapitalization plan has often been necessary.

Under these circumstances we do not believe that the plan meets the statutory requirement of feasibility.

PART 3

RESERVE AND DIVIDEND POLICIES

Mayfair-Cottle Company

While home on terminal leave in November, 1945, Jerome Prescott was offered the positions of treasurer, controller, secretary, and member of the board of directors of the Mayfair-Cottle Company, one of the three leading department stores in his home city. He was then 42 years old. Prior to the war he had been a partner in a medium-sized investment counsel firm in the same city. He accepted the offer and took up his new duties early in December.

The store operated by the Mayfair-Cottle Company was patronized almost exclusively by women. It was an old, well-known store with which people liked to trade. Contrasted with other department stores, it did not carry furniture or men's furnishings, shoes, or clothing. It did not have a bargain basement, candy department, soda fountain, or lunchroom.

After assuming his new duties, Mr. Prescott visited a number of the company's executives for the purpose of obtaining better understanding of the store's operations and its financial problems. After talking with Mr. MacGregor, the chief cashier, Mr. Prescott decided that the company's policies with reference to reserves should be reviewed promptly, for Mr. Prescott learned that Mr. Weiss, the late treasurer, had not followed completely the instructions of the board of directors with reference to "funding" certain reserves.[1]

In December, 1943, the directors had voted to instruct the treasurer to maintain an investment in United States tax anticipation notes[2] in an

[1] When cash or other liquid assets are set aside for the sole purpose of meeting a need for which there is a reserve, the reserve is said to be "funded."

[2] United States tax anticipation notes (Treasury tax savings notes) could be bought at any time at par and could be used at par in payment of federal income taxes. They bore interest at 0.05% per month for the first six months, the rate increasing so that in the period from $2\frac{1}{2}$ to 3 years the rate was 0.11% per month.

amount equal to the estimated liability for income and excess profits taxes. Mr. Weiss had commenced buying these notes in the preceding summer, and it appeared that he had recommended the policy which the directors had adopted.

At the same time, but after considerable debate, the directors had voted to direct the treasurer to invest the full amount of the reserve for postwar requirements in United States Treasury certificates of indebtedness.[3] At the time this reserve amounted to $300,000. It was later raised to $500,000 by vote of the directors. This reserve for postwar requirements was established from surplus to provide for an air conditioning installation, new fixtures for the store, and also increases in working capital necessary because of larger inventories and receivables expected as a result of relaxation of wartime rules and the growth in sales due to higher prices.

Although the directors had set up a reserve of $200,000 for postwar price declines in June, 1945, they did not vote to fund it.

In talking with Mr. Casteel, the vice-president in charge of merchandising, Mr. Prescott learned that the Mayfair-Cottle Company normally borrowed from banks to finance its seasonal needs during the fall and Christmas seasons. Since the company had a long record of profitable operation, the company had never had difficulty in arranging loans. It was Mr. Casteel's understanding that the company could borrow from its bank, currently on 90-day, $1\frac{1}{2}\%$ notes, amounts sufficient to meet these current needs. Because of difficulty in obtaining merchandise for the current Christmas season Mr. Weiss had not thought it necessary to borrow in the autumn of 1945. Instead, Mr. Casteel said, he had provided funds by abstaining from purchasing the full amount of United States tax anticipation notes required by the resolution of the board of directors with respect to funding the reserves.

Mr. Casteel stated that he was not in sympathy with the directors' ideas on the funding of reserves. He expressed the opinion that as soon as inventories and receivables reached normal postwar levels it would be found that the company could not afford to maintain funded reserves during seasonal peaks. Mr. Casteel suggested that Mr. Prescott make a study of the store's seasonal pattern at the earliest opportunity and re-

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[3] United States Treasury certificates of indebtedness were obligations of the U.S. Treasury issued for the term of one year and which, in 1945, carried a 0.875% stated annual rate.

consider the policy on funding reserves in the light of what he discovered.

As he continued his investigation of this matter, Mr. Prescott learned from Mr. MacGregor that the company had four principal depository banks and also maintained balances of about $5,000 in each of two suburban banks. Mr. MacGregor stated that Mr. Weiss had considered $250,000 as the minimum amount of cash and bank balances required for the company's current volume of business. Mr. Prescott had already observed from a study of the record of daily bank balances that the end-of-month cash balance usually ran from $125,000 to $200,000 higher than the month's minimum balance, which usually occurred around the tenth of the month, as many suppliers sold to the store on 10 EOM terms.

From Mr. Walcott, the credit manager, Mr. Prescott learned that the volume of accounts receivable from customers was currently below normal because of Regulation W of the Board of Governors of the Federal Reserve System which had been adopted during the war as an anti-inflationary device. This regulation provided that all charge sales had to be paid for on the tenth day of the second calendar month following the month during which the charge sale was made. The store was prohibited from granting further credit to customers who had failed to pay their accounts within the specified period.

After obtaining this information, Mr. Prescott requested his secretary to bring him monthly financial statements covering the periods of maximum seasonal need in the last two fiscal years. These are presented in Exhibit 1. Mr. Prescott was determined to learn something about the seasonal pattern of the company's finances and to work out a policy with regard to funding reserves that he could recommend to the directors. Knowledge that his predecessor had not been fully complying with the directors' instructions made this question urgent in Mr. Prescott's mind.

In reviewing the figures which his secretary presented to him, Mr. Prescott became confused by the changes in the amounts of reserve for taxes in the two classifications which took place at the end of the fiscal year, July 31, 1945. Mr. Delaney, the chief accountant, told him that at the end of each fiscal year the income and excess profits taxes accrued during the preceding 12 months were transferred out of the "Reserve for Taxes Payable in Next Fiscal Year" to the "Reserve for Taxes Payable in Current Fiscal Year." The sums remained in this account until

paid or adjusted. The "Reserve for Taxes Payable in Next Fiscal Year" was accumulated by monthly entries which would bring the estimated liability up to the most recent estimate of taxes based on income for the fiscal year to date. Mr. Delaney also reminded Mr. Prescott that, since the fiscal year ended July 31, the quarterly tax payment dates were October 15, January 15, April 15, and July 15.[4]

[4] Federal income taxes on corporations are payable in four equal quarterly installments. The first installment is due $2\frac{1}{2}$ months after the end of the company's fiscal year. Thus, companies whose fiscal year ends December 31, must pay their taxes on or before March 15, June 15, September 15, and December 15.

Exhibit 1

MAYFAIR-COTTLE COMPANY

MONTHLY FIGURES, OCTOBER 31, 1944—NOVEMBER 30, 1946

(Dollar figures in thousands)

	Portion of Fiscal Year Ending July 31, 1945										Portion of Fiscal Year Ending July 31, 1946			
ASSETS	Oct.	Nov.	Dec.	Jan.	Feb.	Mar.	April	May	June	July	Aug.	Sept.	Oct.	Nov.
Cash	$ 356	$ 749	$ 733	$ 514	$ 570	$ 493	$ 488	$ 614	$ 581	$ 596	$ 504	$ 415	$ 334	$ 551
Merchandise, net	1,456	1,409	1,062	1,204	1,247	1,246	1,375	1,211	1,174	1,198	1,465	1,398	1,473	1,610
Accounts receivable, net	804	936	1,257	1,160	1,029	1,076	972	825	713	461	470	694	878	990
Miscellaneous current assets	128	129	118	115	120	130	126	126	130	151	144	144	151	145
U.S. tax anticipation notes	655	655	905	755	755	1,005	955	1,080	1,080	930	930	930	730	735
U.S. certificates of indebtedness	300	300	300	300	300	300	300	300	500	500	500	500	500	500
Total current assets	$3,699	$4,178	$4,375	$4,048	$4,021	$4,250	$4,216	$4,156	$4,178	$3,836	$4,013	$4,081	$4,066	$4,531
Fixtures and equipment, net	187	184	181	177	174	171	168	165	161	168	165	163	161	159
Other assets	349	351	353	350	351	354	355	355	355	344	346	350	353	350
Total	$4,235	$4,713	$4,909	$4,575	$4,546	$4,775	$4,739	$4,676	$4,694	$4,348	$4,524	$4,594	$4,580	$5,040
LIABILITIES AND EQUITIES														
Accounts payable	$ 596	$ 584	$ 504	$ 531	$ 502	$ 578	$ 645	$ 466	$ 460	$ 358	$ 518	$ 469	$ 548	$ 755
Accrued expenses	159	184	179	130	141	154	160	177	162	160	173	179	155	189
Notes payable—banks	....	250	250	65	....	....	....	....	....	....	....	....	....	....
Current portion of term loan	55	55	55	55	55	45	45	45	45	45	45	45	45	45
Dividends declared	36	36	36	....	....	....	....	....	....	....	....	....	36	36
Reserve for taxes payable in current fiscal year	561	569	577	414	421	430	236	244	248	114	959	973	757	769
Total current liabilities	$1,407	$1,678	$1,601	$1,195	$1,119	$1,207	$1,086	$ 932	$ 915	$ 677	$1,695	$1,666	$1,541	$1,794
Reserve for taxes payable in next fiscal year	191	330	514	563	594	787	851	919	868	837	...	49	144	255
Noncurrent portion of term loan	225	225	225	225	225	180	180	180	180	180	180	180	180	180
Total debt	$1,823	$2,233	$2,340	$1,983	$1,938	$2,174	$2,117	$2,031	$1,963	$1,694	$1,875	$1,895	$1,865	$2,229
Reserve for postwar requirements	300	300	300	300	300	300	300	300	500	500	500	500	500	500
Reserve against price declines	....	....	....	....	....	....	....	....	200	200	200	200	200	200
Stock and surplus	2,112	2,180	2,269	2,292	2,308	2,301	2,322	2,345	2,031	1,954	1,949	1,999	2,015	2,111
Total	$4,235	$4,713	$4,909	$4,575	$4,546	$4,775	$4,739	$4,676	$4,694	$4,348	$4,524	$4,594	$4,580	$5,040
SALES AND EXPENSE SUMMARY														
Net sales	$ 898	$1,062	$1,377	$ 729	$ 616	$ 984	$ 732	$ 776	$ 697	$ 334	$ 535	$ 805	$1,024	$1,127
Cost of sales	544	641	848	458	384	590	453	473	455	213	340	491	619	673
Net profit before income taxes	154	206	275	73	45	184	86	91	33	96*	6*	99	179	210
Reserved for income taxes	102	139	184	49	31	193	64	68	51*	31*	....	49	95	111
Net profit	52	67	91	24	14	9*	22	23	84	65*	6*	50	84	99

* Negative figure.

Hilton Company

Late in April, 1938, the directors of the Hilton Company met to consider the question of dividend payments. The last dividend had been voted at a meeting on December 28, 1937, payable February 1, 1938, and announced as follows:

> Cumulative convertible preferred stock: a regular quarterly dividend of 25 cents per share.
>
> Common stock: a dividend of 25 cents per share.

The Hilton Company, located and incorporated in Ohio, was an established manufacturer of automatic machine tools, which were used in several industries. A competent engineering staff was continuously employed to carry out improvements in design; these were incorporated in the product as soon as they were proved to be desirable.

It had been the experience of the company over a period of years that the demand for its product was subject to extreme fluctuations. Manufacturers bought new machinery in substantial volume only at times when the actual or prospective profits of their businesses were satisfactory. Consequently, the demand for the product of the Hilton Company was extremely difficult to predict for periods longer than four to six months. A fairly steady volume of repair orders could be expected, but the net earnings of the company varied rapidly from profit to loss, as indicated in Exhibit 1. The demand for replacement parts created a considerable problem of inventory control since over 250,000 items had to be carried in stock.

The capitalization of the Hilton Company which existed in 1938 was the result of a voluntary reorganization that had taken place December, 1937, with the approval of more than 90% of each class of security holders concerned. The reorganization had been put through to accomplish the following announced purposes:[1]

[1] As stated in various letters to stockholders.

1. Simplifying [the corporation's] capital structure;
2. Reducing its outstanding indebtedness; and
3. Enabling the payment of dividends on the new stock proposed to be issued.

With respect to the last of these purposes, the management of the company pointed out that it was necessary to remove the balance sheet deficit in order to make dividend payments legal. No dividends had been paid on the old stock for a number of years. Under the laws of Ohio, dividends could be paid only if the company had a balance sheet surplus. The management stated in a letter to the stockholders that the plan would "make available future earnings for distribution as dividends."

The principal effects of the reorganization upon the company's financial structure are reflected in Exhibit 2. The new shares were exchanged for the old on the following ratios:

SECURITIES OF NEW COMPANY

3 shares of new cumulative convertible preferred stock and 3 shares of new common stock for 1 share of preferred stock and $73.50 accumulated dividends.

$1\frac{1}{2}$ shares of new cumulative convertible preferred stock and $1\frac{1}{2}$ shares of new common stock for 1 share of second preferred stock and $87.50 accumulated dividends.

$\frac{1}{2}$ share of new common stock for 1 share of common stock.

The long-term debt was reduced by the use of treasury cash and funds obtained from the sale of units consisting of one share of convertible preferred stock and one share of common stock of the new company. The units were offered to holders of the new convertible preferred stock; the only actual sales were to a group of officers and directors of the company who had agreed in advance to exercise the rights that they would receive as a result of the new financing. About $675,000 was obtained from these persons.

The balance of the old long-term debt was replaced by the new serial loan of $900,000, which was placed with a commercial bank in Chicago. The company agreed to retire this loan in annual installments of 20% of the company's net earnings in a fiscal year, or $110,000, whichever sum was the greater. It had the privilege of making these payments at any time during the year. Interest was to be charged on outstanding balances at the rate of 4% per annum for the first year, $4\frac{1}{2}$% for the second year, then 5% to maturity. The company agreed that the entire loan should become due at any time when the total cur-

Exhibit 1

HILTON COMPANY

INCOME DATA

(Dollar figures in thousands)

		Sales	Depreciation	Income Taxes	Net Income after Taxes
	1930	$3,072	$217	...	$585[d]
	1931	2,775	218	...	315[d]
	1932	1,487	191	...	519[d]
	1933	2,788	179	$ 10	171
	1934	4,868	186	75	389
	1935	2,975	188	...	9
	1936	5,234	190	215*	535
	1937	7,160	205	350*	476
Jan. 1–Mar. 31	1938	1,731	62	20	115
Mar. 1–31	1938	482	18	4	29

* Includes provision for federal surtax on undistributed profits of $92,000 in 1936 and $131,000 in 1937. This surtax was established by the Revenue Act of 1936. Since repeal of this surtax appeared imminent early in 1938, allowance for income tax in the period January–March, 1938, represented allowance only for the normal tax of 15% of net income for the quarter.

[d] Deficit.

Exhibit 2

HILTON COMPANY

BALANCE SHEET AS OF MARCH 31, 1938

(Dollar figures in thousands)

ASSETS

Cash	$ 720		
Receivables, net	1,664		
Inventories (estimated*)	1,013		
Current assets		$3,397	
Notes receivable after one year		70	
Special insurance deposits		35	
Inactive inventory, net		48	
Unmarketable securities, net		80	
Treasury stock		1	
Deferred charges		8	
Plant accounts, net		2,795	
Total assets			$6,434

LIABILITIES, CAPITAL, AND SURPLUS

Accounts payable	$ 87		
Accrued liabilities	284		
Current installments of serial loan	110		
Current liabilities		$ 481	
Serial notes		790	
Reserve for federal income tax		131	
Preferred stock (78,350 shares at $20)		1,567	
Common stock (106,400 shares at $5)		532	
Surplus, December 17, 1937		2,864	
Earned surplus		69	
Total liabilities, capital, and surplus			$6,434

* In preparing interim statements, the treasurer estimated inventory values according to a formula which had proved to be reliable. Physical inventories were taken only at the end of the fiscal year.

rent assets of the company, after the deduction of all indebtedness except for the outstanding serial loan, should be less than one and one-half times the loan balance.

The stock of the company was widely held in Ohio and neighboring states. It was unlisted and had a small turnover. No stockholder held a controlling interest in the company, the largest individual holding representing about 15% of the voting stock. Five other individuals each held about 2½% of the stock.

At their meeting in April, 1938, the directors were given the information presented in Exhibits 2 and 3. The president pointed out that it was clear that many of the company's customers would experience operating and other losses at least for the first half-year. Inventories were large, and prices were at very low levels.

The president stated that, because of the considerable backlog of orders carried forward by the company from the previous summer, operations through the winter months had shown some profit, especially in December and January. He pointed out, however, that the contraction

Exhibit 3

HILTON COMPANY

INCOME STATEMENTS

JANUARY 1, 1938, TO MARCH 31, 1938,

AND MONTH OF MARCH, 1938

(Dollar figures in thousands)

	Jan. 1, 1938—Mar. 31, 1938	*Mar. 1938*
Total sales	$1,731	$482
Cost of goods sold and expenses of operation	$1,518	$428
Depreciation of active plant	45	13
Total operating expenses	$1,563	$441
Net operating income after depreciation	$ 168	$ 41
Dividends, interest, royalties	7	3
Total income	$ 175	$ 44
Interest on long-term debt	$ 13	$ 3
State taxes and federal income tax	4	2
Provision for federal income tax*	20	4
	$ 37	$ 9
Net expenses on inactive plants	$ 3	$ 1
Depreciation of inactive plants	17	5
Losses on inactive plants	$ 20	$ 6
Nonrecurring losses	3	..
Net income	115	29
Dividends paid (February, 1938)	47	..

* 15% normal tax only.

in new business bookings which had set in early in the fall was continuing and that such bookings were now running at the lowest rate in several years. Reference was also made to the curtailed rate of operations in effect at the company's plants and to the uncertain future for business generally. The assistant treasurer of the company estimated that losses for April would amount to more than $40,000 but that operations in May would probably result in a small profit.

Nostrand Pressure Casting Company

During November, 1941, the directors of the Nostrand Pressure Casting Company met to consider what dividend, if any, should be paid on the common stock in December. The company had paid dividends quarterly through 1940 and 1941, in amounts as shown in Exhibit 1, and the directors had adopted a policy of paying dividends as regularly as possible. Despite a change in the nature of production from civilian to military products, volume and profit margins had been maintained through 1941, as shown in Exhibit 2. Exhibit 3 contains selected balance sheet items for various dates. In November, 1941, it was estimated that the figures for the entire year would show improvement over those of 1940. Nevertheless, certain directors questioned the advisability of a further cash distribution to stockholders because of recent capital expenditures for defense plant, probable increased income taxes in 1942, and a desire to improve the working capital position so that the company would be better able to care for any contingencies that might arise. One director also pointed out that annual dividends totaling $2.50, the 1940 rate, gave a yield or return of almost 6% on the current market price of the common stock.

In 1941 the Nostrand Pressure Casting Company was an important manufacturer of nonferrous die castings, made by forcing molten metal into metal molds or dies. Somewhat less than half of the parts made in a normal year were for automobiles and accessories, and the remainder were made for many kinds of products. Thus, although it was the company's policy to manufacture on order only, the diverse nature of the demand caused the seasonal variation to be small. In peacetime the company's demand for metals was about 50% for zinc, 40% for aluminum, and the balance for copper, magnesium, and lead. During 1940 and 1941, because of defense priorities, the company used the maximum

amounts of aluminum allowed by the U.S. Office of Production Management (O.P.M.) and the total amount of zinc allocated on its orders. Due to the decrease in zinc available, some auto parts and some other parts formerly produced in zinc alloy were converted to lead.

As the defense program advanced, the nature of the company's orders changed. By November, 1941, 50% of the company's output was on defense parts, and it was anticipated that 90% of the output for 1942 would be for military purposes. Most of the company's defense orders were on subcontracts; and, on the whole, orders came from the same customers who had been buying from the company in peacetime. In negotiating these new contracts, the company continued its policy of limiting contracts to cover not more than 90 days' production, so that prices could be adjusted easily to changing costs. Since the company continued to sell to the same customers, its rate of collection of receivables continued to be less than 30 days.

With respect to inventories, the company's peacetime policy was to carry amounts of metals which were seldom in excess of the quantity needed for four weeks' production. A great deal of magnesium was needed in certain of the castings made for war purposes, and the company adopted a policy of carrying two or three weeks' supply of this metal. In November, 1941, the O.P.M. ruled that companies should not carry more than a four weeks' supply of aluminum, a six to eight weeks' supply of copper, a two to three weeks' supply of magnesium, an eight weeks' supply of lead, and zinc only as needed for immediate use.

Early in 1940 the company embarked upon a program of modernizing and expanding its plant facilities. Much of the expansion was completed in 1940, and by November, 1941, all but \$200,000 of an original capital budget of \$1,500,000 had been expended. The balance was to be expended by the end of 1941. All the funds for the expansion and modernization had been provided from internal sources. It was expected that no further substantial investment in plant or equipment, other than reinvestment of depreciation, would be required, since the company's capacity seemed ample for the foreseeable demand.

The management of the Nostrand Pressure Casting Company had found that the question of providing funds for taxes was of ever-increasing importance. Property, franchise, and similar taxes were not varying greatly from year to year, but taxes based upon income—chiefly the federal income, excess profits, and defense taxes—were becoming larger. Such taxes were levied upon the income of a certain year and were pay-

Exhibit 1

NOSTRAND PRESSURE CASTING COMPANY

DIVIDENDS PAID PER SHARE OF COMMON STOCK

1940 AND FIRST THREE QUARTERS OF 1941

1940	
April 1	$0.50
July 1	0.50
Oct. 1	0.50
Dec. 31	1.00
	$2.50
1941	
April 1	$0.50
July 1	0.50
Oct. 1	1.00

able during the following year, so that the company adopted the policy of reserving funds quarterly, based upon the current earnings and expected tax rates. A current liability was set up for the taxes to be paid in the ensuing four quarters, and current assets were earmarked accordingly. Taxes payable in later quarters were also estimated but not carried as current items. At the end of each quarter, the company's probable tax liabilities were recomputed in the light of estimates of earnings and of probable tax rates.

Exhibit 2

NOSTRAND PRESSURE CASTING COMPANY

PROFIT AND LOSS FIGURES, VARIOUS PERIODS, 1940–1941

(Dollar figures in thousands)

	October 1940	*October 1941*	*10 Months 1940*	*10 Months 1941*	*12 Months 1940*
Net sales	$1,380	$1,360	$8,660	$14,387	$11,231
Gross profit	259	353	1,731	3,401	2,801
Operating profit, before depreciation	186	275	1,175	2,520	1,764
Net profit before federal income taxes	172	245	1,046	2,172	1,394
Estimated federal income taxes	89	170	431	1,344	619
Profit after taxes	83	75	615	828	775

Earnings in 1941 were taxable at rates established by the Revenue Act of 1941. In November, 1941, management anticipated that a new revenue act providing for a significant increase in taxes would be passed and would apply to income earned in 1942.

After August 1, 1941, the company commenced to purchase U.S. Treasury Series B tax notes for the purpose of accumulating funds to pay taxes in 1942. These notes were dated August 1, 1941, to mature Au-

Exhibit 3

NOSTRAND PRESSURE CASTING COMPANY

BALANCE SHEET ITEMS AS OF VARIOUS DATES, 1940–1941

(Dollar figures in thousands)

ASSETS	1940		1941			
	Oct. 31	*Dec. 31*	*Mar. 31*	*June 30*	*Sept. 30*	*Oct. 31*
Cash:						
Unallocated	$ 72	$ 92	$ 81	$ 376	$ 541	$ 466
Reserve for vacation pay, etc.	83	....	128	103	110	128
Reserved for taxes	439	727	952	1,204	752	343
Tax notes, 1942 use	....	....	....	....	750	1,126
Accounts receivable, net	1,208	1,202	1,416	1,281	1,118	1,195
Notes and acceptances receivable	13	20	8	7	18	19
Inventory:						
Finished goods	281	227	167	128	88	139
Goods in process	246	226	296	288	308	287
Materials and supplies	223	288	657	647	589	545
Current assets	$2,565	$2,782	$3,705	$4,034	$4,274	$4,248
Investments	$ 31	....	....	....	....	$ 67
Plant, after depreciation	3,029	....	....	....	....	3,234
Deferred expenses	150	....	....	....	....	160
Total assets	$5,775	....	....	....	....	$7,709

LIABILITIES AND CAPITAL						
Accounts payable	$ 565	$ 661	$ 721	$ 568	$ 528	$ 449
Accrued salaries, wages, etc.	280	256	197	240	262	234
Taxes due within 12 months:						
Due this year	34	....	616	415	277	206
Due next year	406	618	395	790	1,225	1,262
Miscellaneous current	45	37	48	50	53	53
Current liabilities	$1,330	$1,572	$1,977	$2,063	$2,345	$2,204
Estimated taxes due after 12 months	167	....	234	422	195	375
Liability for customers' dies	56	132	242	286	321	326
Total liabilities	$1,553	$1,704	$2,453	$2,771	$2,861	$2,905
Common stock, 105,194 shares	2,104	....	....	....	....	2,104
Surplus	2,118	....	....	....	....	2,700
Total liabilities and capital	$5,775	....	....	....	....	$7,709

Exhibit 4

NOSTRAND PRESSURE CASTING COMPANY

MONTHLY HIGH AND LOW QUOTATIONS

1941	Nostrand Common Stock High	Nostrand Common Stock Low	Dow-Jones Averages of Industrial Common Stocks High	Dow-Jones Averages of Industrial Common Stocks Low
January	46¼	42	133.94	123.86
February	46¼	41	125.13	117.57
March	45	40¾	124.20	119.98
April	41	34¾	125.28	115.33
May	40	34¼	118.45	114.78
June	39	34½	125.14	115.52
July	38½	34¾	130.37	122.54
August	36¾	34¼	128.69	124.66
September	44	36½	130.00	125.33
October	43¾	39¼	127.20	117.40

gust 1, 1943. The purchase price was at par and accrued interest, the rate of interest being 4 cents per month per $100. These notes could be used at par and accrued interest during and after the third month from purchase for the payment of liabilities on various federal taxes based upon income. The interest earned by these notes was not exempted from the federal income tax. The notes could be redeemed without interest on 30 days' notice, after the first 60 days.

The stock of the Nostrand Pressure Casting Company was widely held. No single interest owned more than 10% of the stock. The shares were listed on an important stock exchange, and the record of the 1941 market prices through October appears in Exhibit 4. The board of directors of the company numbered ten, four of whom were officers of the Nostrand Pressure Casting Company, two were partners of investment banking firms, one was the vice-president of the principal commercial bank used by the company, and the others were executives of industrial concerns.

Curtiss-Wright Corporation[1]

In April, 1948, holders of the Class A and the common stock of the Curtiss-Wright Corporation received a letter from a committee of three shareholders who claimed to own 16,500 shares of the common stock. In their letter, this committee asked support at the forthcoming annual meeting of the shareholders for eight nominees to the eleven-man board of directors of the corporation. According to the committee, the management should be criticized for accumulating excess liquid funds and for discrimination against the common stock in favor of the Class A stock with reference both to dividends paid over several years and to the purchase and retirement of the Class A stock in 1947.

If elected, the eight nominees would support the immediate payment of a cash dividend of $7.00 per share on the common stock (requiring $52,024,273) or, as an alternative, the retirement, by solicitation of tenders, of as many as 3,716,020 shares (50% of the outstanding amount) of common stock at $14 per share (requiring $52,024,280).

Responding to this appeal, the management of the Curtiss-Wright Corporation, in a letter to stockholders signed by G. W. Vaughan, the president, stated that a partial liquidation "at this time" would jeopardize the future of the company. Reviewing past dividends, the letter pointed out that over the past 14 years, dividends to common shareholders had amounted to $39,000,000 compared with $23,000,000 paid to Class A shareholders. Referring to the purchase and retirement of Class A shares in 1947, the letter stated: "The charter of the Corporation requires the payment of $2.00 per share on the Class A stock in any one year before any dividends may be paid on the common stock. Therefore, the purchase by your company of Class A stock at a reasonable price improved the capital structure of your company."

In conclusion, the letter urged the shareholders to sign an enclosed proxy, supporting management nominees for the eleven directorships.

[1] The material in this case is from various published sources.

The Curtiss-Wright Corporation began business in August, 1929, as a holding company. For many years previous to this the various subsidiaries of the company had been engaged in the manufacture of aircraft and engines for aircraft. These companies were acquired by means of exchange of shares of the two classes of Curtiss-Wright stock for the stock of the subsidiaries. Through such exchanges the Curtiss-Wright Corporation acquired well over 90% ownership in all the subsidiary companies. In 1936 all of the principal subsidiaries were dissolved, except Wright Aeronautical Corporation, and the operations were taken over by the parent company.

On May 29, 1936, Curtiss-Wright Corporation offered directly to both classes of stockholders about 800,000 common shares at $4.00 per share. These shares were offered on the basis of one share for every 10 shares of Class A or common held. Warrants for 644,453 shares were exercised under this arrangement.

The provisions of the two classes of stock are summarized in Exhibit 1. The record of market prices in recent years appears in Exhibit 2.

From 1929 to 1936 the Curtiss-Wright Corporation experienced difficult times. A loss of over $9,374,000 was suffered in 1930 alone. In 1936 the business outlook became definitely better as sales increased over 70% in one year. This upward trend in sales and profits continued until 1945, when sales reached $1.1 billion and profits, after taxes, $24.4 million. The record of sales and profits appears in Exhibit 3.

The prosperous period of 1936–1945 permitted the building-up of the company's working capital. In this period the company had net profits of $118 million. From these profits were deducted dividends of $51 million, leaving $67 million plus depreciation charges of $52 million, or $119 million in funds provided by operations. By December, 1945, net working capital reached $138 million; and in December, 1946, the sum was still $110 million after capital expenditures of $17 million in that year. At a special stockholders meeting in 1947, Mr. Vaughan spoke of an "excess" of some $60 million in net working capital. Balance sheets of the company in recent years appear in Exhibit 4.

In 1944 a policy of nonaviation diversification was commenced with the purchase of the L. G. S. Spring Clutch Corporation. This was followed in 1945 by the acquisition of Marquette Metal Products Co., a manufacturer of metal textile spindles. The Victor Animatograph Corp., one of the largest producers of 16 mm. film projectors, cameras, and accessories, was purchased in mid-1946. All three companies were pur-

Exhibit 1

CURTISS-WRIGHT CORPORATION

SUMMARY OF PROVISIONS OF CAPITAL STOCK ISSUES

PAR VALUE	*Class A*: $1.00. *Common*: $1.00.
REDEMPTION	*Class A*: In whole or in part at any time at $40 per share and declared dividends, if any.
CONVERSION	*Class A*: Into common, share for share, at any time at the option of the holder.
DIVIDENDS	*Class A*: Noncumulative, but entitled to not more than $2.00 per share in any year, if declared, before any dividend can be paid on the common stock. *Record of dividends since the formation of the company*: "Your company is not and never has been on a regular basis as far as dividends are concerned, but they are declared at the discretion of the directors of your corporation."

	ANNUAL PAYMENT	
YEARS	*Class A*	*Common*
1929–1935	None	None
1936–1937	$0.50	None
1938	1.00	None
1939	2.00	None
1940	2.00	$0.50
1941–1942	2.00	1.00
1943–1944	2.00	0.75
1945–1946	2.00	0.50
1947	2.00	0.25

VOTING RIGHTS	One vote per share.
RESTRICTIONS	Consent of $\frac{2}{3}$ of Class A then outstanding required to increase issue of Class A or common.
PRE-EMPTIVE RIGHTS	None for either class; yet in 1936 subscription rights for new common were offered to each class at the same subscription ratio.
LIQUIDATION	Each share of Class A and of common is entitled to the same payments, unless in the case of voluntary liquidation the holders of more than $\frac{1}{3}$ of the then outstanding Class A object in writing within a period of 20 days.

Exhibit 2

CURTISS-WRIGHT CORPORATION

PRICE RANGE ON CLASS A AND COMMON STOCKS

Year		Price Range: Class A	Price Range: Common
1932		3 3/8– 1 1/2	3 1/4– 7/8
1933		8 – 2	4 3/8–1 1/2
1934		12 1/4– 5 1/4	5 1/4–2 1/8
1935		12 1/4– 6 1/4	4 5/8–2
1936		21 7/8–10 1/2	9 1/4–4
1937		23 3/4– 8 1/8	8 3/8–2
1938		28 1/4–12 5/8	7 3/8–3 1/4
1939		32 1/2–19 1/4	13 1/4–4 1/4
1940		32 3/8–21 1/4	11 3/8–6 1/2
1941		29 1/2–24	10 1/4–6 7/8
1942		25 7/8–18	9 1/8–5 7/8
1943		24 1/2–14 5/8	9 1/2–5 1/2
1944		19 1/4–14 3/4	7 3/8–4 5/8
1945		30 1/8–18 1/4	9 –5 1/2
1946		34 1/4–17 1/8	12 1/8–5 3/8
1947	1st quarter	20 1/4–18 3/8	6 3/8–5 1/2
	2nd quarter	19 –12 7/8	5 3/4–4 1/8
	3rd quarter	19 1/4–14 1/4	5 7/8–4 3/8
	4th quarter	21 1/2–16 1/2	6 –4 1/4
1948	1st quarter	24 1/8–18 3/4	6 7/8–4 3/8

chased for cash. Discussing these acquisitions in 1947, Mr. Vaughan stated that any additional enterprises that might be acquired would be of a type with which the management was familiar.

On November 3, 1947, the company issued a call for tenders for as many as 500,000 shares of Class A stock at $20.50 per share ($10,250,000). This offer resulted in the redemption of 204,983 shares at a cost of $4,215,684, of which amount $204,983 was applied in reduction of the par value of the Class A stock which was canceled and the balance was applied against earned surplus. In connection with the request for tenders, the company stated that it had not purchased any of its stock in the open market or otherwise.

The backlog of research and production orders on hand in early 1948, in the opinion of the management and the opposition committee, was sufficient to assure profitable operations for more than a year without consideration of anticipated new orders from commercial and government sources. (As it developed, 1948 sales were about $112 million, and profits after taxes $5 million.)

Exhibit 3

CURTISS-WRIGHT CORPORATION

OPERATING RESULTS

(Dollar figures in thousands)

Year	*Sales*	*Provision for Federal Income Tax*	*Provision for War and Postwar Contingencies*	*Net Income or Loss*[d]	*Net Income per Share of Class A*	*Net Income per Share of Common**
1932	$ 12,407	.....	.....	$ 742[d]	....	...
1933	10,451	.....	.....	21[d]	....	...
1934	14,009	$ 40	.....	164	$ 0.14	...
1935	11,119	.....	.....	172[d]	....	...
1936	18,929	395	.....	1,018	0.88	...
1937	24,116	501	.....	1,983	1.71	...
1938	33,103	899	.....	3,599	3.11	$0.17
1939	48,654	1,456	.....	5,218	4.50	0.39
1940	138,720	27,886	.....	15,747	13.59	1.81
1941	373,083	91,535	$ 7,230 dr.	25,717	22.20	3.15
1942	770,595	76,381	7,993 dr.	13.143	11.34	1.46
1943	1,295,236	86,012	9,088 dr.	12,883	11.12	1.42
1944	1,716,935	79,480	8,520 dr.	14,331	12.37	1.61
1945	1,197,705	64,800	486 cr.	24,430	21.08	2.97
1946	71,984	25,000 cr.†	11,300 cr.	2,472	2.14	0.02
1947	83,162	7,409 cr.†	937 cr.	1,365[d]	....	...

* After allowance at $2.00 per share on Class A stock.

† Claim for refund under loss carry-back provisions of Internal Revenue Code.

[d] Deficit.

NOTE: In addition to the income stated above, there was credited to earned surplus in the years 1945, 1946, and 1947, $17,401,000, $7,133,000, and $21,393,858, respectively, consisting principally of reductions in service guaranty reserve, estimated federal taxes on income provided in prior years, and, in 1947, provision for war and postwar contingencies.

Exhibit 4

CURTISS-WRIGHT CORPORATION

CONSOLIDATED BALANCE SHEETS AS AT DECEMBER 31

(Dollar figures in thousands)

ASSETS

	1946	*1947*
Cash in banks	$ 26,472	$ 10,908
Government securities	60,450	64,616
Accounts receivable	15,966	17,475
Claim for refund	25,000	9,700
Inventories	29,281	31,907
Termination claims	8,539	1,381
Total current assets	$165,709	$135,987
Prepaid expenses	423	294
Plant facilities, net	19,318	25,369
Real estate and machinery held for disposal	5,162	275
Mortgages and investments	2,659	4,272
Total assets	$193,272	$166,198

LIABILITIES

	1946	*1947*
Accounts payable—trade	$ 5,178	$ 5,101
Accrued wages and taxes	7,136	4,015
Advances on contracts	10,662	6,244
Accounts payable—United States government	931	1,291
Provision for federal taxes	25,397	13,918
Termination claims payable	3,765	754
Other liabilities	2,289	1,324
Total current liabilities	$ 55,360	$ 32,646
Reserves:		
Service guaranty	$ 4,600	$ 4,425
Insurance	200	200
War and postwar contingencies	21,045	5,000
	$ 25,845	$ 9,625
Minority interest	1,630	1,625
Capital stock:		
Class A stock—$1.00 par	1,159	954
Common—$1.00 par	7,432	7,432
Capital surplus	15,325	15,347
Earned surplus	86,521	98,569
Total liabilities	$193,272	$166,198

PART 4

PROMOTION, EXPANSION, COMBINATION

Leary Motors

Mr. Paul A. Leary, a successful sales representative for a High Point, North Carolina, furniture manufacturer, had an opportunity in July, 1946, to purchase a High Point automobile dealership on what he considered favorable terms. After taking an option to buy the firm, he set about arranging to raise the $75,000 necessary to cover the purchase price of $60,000 and to provide needed working capital of $15,000. In the course of discussions about the financing of the enterprise, the question came up of whether the new firm would be operated as a proprietorship, a partnership, or a corporation. Mr. Leary felt that he should reach an early decision on the matter.

Although his position in the furniture company necessitated travel for about three weeks out of each month, Mr. Leary managed to take an active part in the civic and social affairs of his community. At 55 he owned his home, worth $20,000, free of any lien. In addition to several life insurance policies with aggregate cash surrender value of $16,750, he owned approximately $15,000 of liquid funds plus some securities, currently worth about $8,000, which he desired to retain as investments. His two children, Paul, Jr., and Judy, were 26 and 23, respectively. His daughter was a college graduate employed as secretary to an insurance general agent in High Point. Paul, Jr., had left college in 1941 to enter the army, where he served as an infantry officer; he had been married on his terminal leave in the fall of 1945 and returned to finish his last year of college. He graduated in June, 1946, with a Bachelor of Arts degree in economics.

Mr. Leary wanted to give his son an opportunity to prove himself as an administrator, but he also wanted to provide him with sufficient financial incentive to stay in High Point rather than to accept a position with a large textile firm in Greensboro. When he learned that the local

dealer of one of the independent car manufacturers was contemplating retirement, Mr. Leary talked with him and took an option to buy the going concern. While this particular make of car had accounted for only a small segment of the market before the war, it had gained considerable popularity in the postwar market and was increasing its percentage of total passenger car sales.

Although the retiring dealer had shown him tax returns for the past several years, Mr. Leary wanted to get some estimate of the future income possibilities of the dealership. He therefore contacted Mr. Jordan, district representative of the car manufacturer. The latter estimated an annual net profit for the dealership of approximately $10,000 before taxes but after allowing for a $5,000 salary to be paid to Paul, Jr. This seemed in line with Mr. Leary's estimates based upon what the retiring dealer had showed him.

Having satisfied himself concerning the potential profitability of the dealership, Mr. Leary outlined his plans to the officers of a local bank where he was well known and highly regarded. He mentioned his desire to have his son manage the business on a salary basis and to have his daughter share equally with his son and himself in any profits. The bankers expressed a willingness to help with the financing of the new venture and suggested that it be incorporated to limit Mr. Leary's liability in view of his limited participation in the management. The bankers agreed to loan $60,000 on the condition that Mr. Leary invest $15,000 cash in the business. Of the bank's total participation $35,000 was to be secured by a mortgage on the building and fixtures, which were valued at $50,000; $10,000 was to be an unsecured note of the corporation or partnership endorsed by Mr. Leary; and $15,000 was to be a personal note signed by Mr. Leary.

Mr. Leary was not completely satisfied that incorporation was a proper step. Later, during franchise negotiations with Mr. Jordan, he raised the question of the organizational form of his dealership. Mr. Jordan explained that his office received monthly operating reports from each dealer in the district. In this manner the manufacturer could control adequately dealer activities, regardless of the form of individual organization. Mr. Jordan further pointed out that only one person, designated as the dealer, signed the franchise agreement. Article 12 of this document stated: "This Franchise Agreement constitutes a personal contract, and Dealer shall not transfer or assign this Franchise or any rights hereunder. . . ."

Exhibit 1

LEARY MOTORS

NORTH CAROLINA RESIDENT'S INCOME TAX RATES

Brackets of Taxable Income	*Incremental Tax Rate*
0–$ 2,000	3%
Next $ 2,000	4
Next $ 2,000	5
Next $ 4,000	6
Over $10,000	7

Exemptions:

Single	$1,000
Married	2,000
Each dependent	200

Exhibit 2

LEARY MOTORS

FEDERAL PERSONAL INCOME TAX RATES

Brackets of Taxable Income	*Combined Normal and Surtax Incremental Rates 1945 Act*
0–$ 2,000	19%
$ 2,000–$ 4,000	21
$ 4,000–$ 6,000	25
$ 6,000–$ 8,000	28
$ 8,000–$10,000	32
$10,000–$12,000	36
$12,000–$14,000	41
$14,000–$16,000	45
$16,000–$18,000	48
$18,000–$20,000	50

Exemptions:

For taxpayer and each dependent, $500.

In order to clarify his thinking about the form of organization for his new enterprise, Mr. Leary sought the advice of his lawyer, Mr. Riley. The counsellor first cautioned him to make certain that he had adequate insurance coverage for his property and for protection against claims and liabilities resulting from work done by men in the garage. In addition to adequate insurance Mr. Riley felt that the limited liability feature of corporate organization would be beneficial. He said it was desirable to incorporate in order "to operate the business as a distinct entity." Incorporation, he pointed out, could be accomplished at a cost of about $250, including all fees and initial taxes. Furthermore, if at any time it might be desirable to divest the business of its corporate form, this could be done with very little trouble. Finally, Mr. Riley remarked that he believed certain tax advantages would accrue as a result of incorporation.

Exhibit 3

LEARY MOTORS

COMPARATIVE TAX ESTIMATES BASED UPON NET INCOME OF $10,000

BUSINESS IN CORPORATE FORM

	Incremental Rate		Total	
	Normal (%)	Surtax (%)	%	Amount
Federal Corporate Taxes:				
Normal income tax:				
First $5,000 taxable income	15	6	21	$1,050
Next $5,000 taxable income	17	6	23	1,150
Old age benefits tax (1% of $3,000—maximum)				30
Unemployment insurance tax (3% of $3,000—maximum)				90
Total federal taxes on corporation				$2,320
State Corporation Taxes (North Carolina):				
Income tax at 6%*	$600			
Franchise tax ($1.50 per $1,000 of capital)	23			623
Total federal and state taxes on corporation				$2,943

Federal and State Taxes on Dividends:†		
Mr. Leary:		
State income tax	$ 66	
Federal income tax	386	
Son:		
State income tax	38	
Federal income tax	235	
Daughter:		
State income tax	28	
Federal income tax	188	941
Total taxes resulting from corporate organization ‡		$3,884

BUSINESS CONDUCTED AS PARTNERSHIP

Federal income tax on Mr. Leary's share of earnings	$1,470
State income tax on Mr. Leary's share of earnings	233
Federal income tax on son's share of earnings	873
State income tax on son's share of earnings	160
Federal income tax on daughter's share of earnings	723
State income tax on daughter's share of earnings	127
Total federal and state taxes on partnership organization	$3,586

* Federal income taxes not deductible.
† Total dividends amount to $2,823, after 60% of net income is reinvested in business.
‡ Does not include taxes ultimately levied on earnings not currently distributed.

Mr. Leary felt that it would be inadvisable to operate the business as an individual proprietorship because the profits of the enterprise would be added for tax purposes to his average earnings of $14,000 annually from the furniture company (see Exhibits 1 and 2 [p. 317]). He was aware of the double taxation of corporate profits and individual income in the form of dividends paid from those corporate profits; however, he was not sure what other taxes his firm might incur as a corporation which it could avoid as a partnership.

In view of the fact that debt would be substantial in relation to invested capital, Mr. Leary decided that initially 60% of any profits earned would be retained in the business. Additionally, Mr. Leary believed that there might be some question regarding an equal split of profits under any organizational form since he was putting up the entire equity capital. Nevertheless, he hoped that, if his son spent full time on the business and if his daughter acted in some official capacity, even part time, division of profits into three equal shares could be justified.

After some research in the local library, Mr. Leary made some comparative tax estimates (see Exhibit 3 [p. 318]). The estimates were based upon Mr. Jordan's income forecast and the facts that the personal income of Mr. Leary's daughter was $2,000 and that his son had no other income than that which his job would yield.

Supra Development Corporation

In early August, 1947, Mr. Stuart Hale faced the problem of how he and two associates should best finance the manufacture and sale of a new power wood- and metalworking tool. Work on the project had progressed to a point where it appeared that the product was basically a good one, that it fulfilled an apparent need, and that it could be produced at a reasonable price. Preliminary investigations suggested a wide market acceptance. Mr. Hale felt that the time had come to give careful consideration to the financial aspects of promoting the new venture and how the financial aspects might influence the production and marketing plans.

The product was the invention of Mr. Fritz Schneider. Mr. Schneider had been educated as an engineer in Europe. In 1937, he emigrated to America from his native Austria. On a total capital of about $500 he set up a woodworking business in Houston, Texas, to produce and sell several small consumer products which he had invented. The inventions were generally regarded as good ones and later were exploited successfully in varying forms by other concerns. The business proved unsuccessful, however, and in 1939 Mr. Schneider accepted an engineering position with a local shipyard.

His woodworking experience in the United States had convinced Mr. Schneider that there was a real need for a power tool which would combine the functions of a number of tools currently produced. He felt that the function of a lathe, circular saw, disc sander, and horizontal and vertical drill press could be combined in a single unit. Some such multipurpose units had been attempted but had met with limited success. Those tools that had been produced were bulky; it took several minutes to change from one working setup to another, and for each use the tools were less satisfactory than individual tools for the purpose on the market.

The end of the war, with resultant cuts in overtime work, gave Mr. Schneider more time to work on his idea. In the basement of his Houston home, he developed a small wooden model of a tool. By changing the setup of the tool, each of the five functions could be performed effectively. In January, 1947, he left his shipyard job and put his full time on a larger metal model.

As his work progressed, he became convinced that he had successfully overcome the problems that had prevented other multipurpose tools from being successful. Accordingly, he contacted Mr. Tom Hale, a young businessman and former associate at the yard. Mr. Hale was only 28 years of age but had built up quite a reputation at the shipyard as an enterprising and able businessman. Since the war, Mr. Tom Hale had been associated with the promotion of a new product and had acquired considerable experience in this kind of work.

After a study of the product, Mr. Tom Hale interested an older brother, Stuart, in it. Stuart Hale was also young, but he had achieved an outstanding record in college and at a graduate school of business administration. Following graduation he worked for a large New York department store before going on active duty with the quartermaster corps of the army. After the war, he had moved to Houston and undertook to expand the production and sales of an industrial product. Although he had been successful in building up the sale of this product to a degree, the product was such that its maximum possibilities seemed limited.

After much discussion the Hale brothers agreed to undertake to promote Mr. Schneider's invention. It had been their experience that inventors often were inclined to underestimate the importance of the business aspects of getting a new product produced and on the market. Several inventors they had known seemed to have the idea that great profits almost automatically accrued to a successful inventor. They found, however, that Mr. Schneider appreciated the difficulties involved, and after some discussion they reached an agreement. Under the agreement a company would be formed with the common stock ownership shared equally by the three men. The administration would rest primarily with the Hales. Mr. Schneider, who was married and had a family, would receive a salary of $100 a week from March 1, 1947, and would spend his time on the improvement of the product and ultimately on development of new ideas. He had exhausted his personal funds in the development of the product to date and had no further resources to in-

vest in business. The responsibility for raising funds to finance the business would rest with the Hales.

Before setting up the new business, and while retaining their other jobs, the Hales worked evenings and on week ends on the further development of the product. Through friends they learned of an engineer especially capable in production design. On April 15 this man was hired to work on the project. By July 1 the joint efforts of the production engineer and Mr. Schneider resulted in a second metal model, designed for ease of production as well as efficiency of operation. Detailed production drawings were also prepared. At this stage all concerned were convinced that the improved model was superior in each of its five major functions to the one-function power tools on the market and that it could be produced at a reasonable price.

Thereupon, early in July, 1947, the Hale brothers resigned their other positions and prepared to devote full time to the project. They planned to draw no salaries until the business was firmly established.

In an informal division of duties Mr. Stuart Hale decided to concentrate on the problems in the marketing area and Mr. Tom Hale on production problems. Mr. Stuart Hale first turned to consideration of where the market lay for his product. A study of the sales of home tools, such as power lathes and saws, indicated that the principal buyers were home craftsmen. In garage or basement workshops these craftsmen undertook the building of furniture and other articles for the home both as a hobby and as a means of reducing the cost of home articles and home repairs. In addition to these amateur craftsmen, some carpenters and small contractors also purchased light power tools.

His preliminary investigations suggested that the compactness, ease of use, and the feature of five basic tools, lathe, circular saw, disc sander, and horizontal and vertical drill press in one unit, would be major selling points for the machine. After much discussion, the wife of Mr. Tom Hale thought of a name for the tool—"Quin-Craft"—which was adopted. At the same time it was decided to call the new corporation to be formed the "Supra Development Corporation."

It appeared to the Hales that price would be very important in determining the extent of the potential market for the tool. It seemed highly desirable that the price for the Quin-Craft be significantly less than the combined price of the five individual tools. Since many of the home craftsmen were working men or relatively low-paid clerical people the price should be within their financial capacity.

Although they had learned of no competing multipurpose tools being developed, it was felt that a successful development of the tool would inspire competitors to enter the field. A high price with apparent high profits would encourage the development of such competition. On the other hand, the Hales were determined to produce a rugged, high-quality product. Any weakness or failure in the product would, they felt, be disastrous to the new company. In addition, the cost of producing the Quin-Craft was highly uncertain. The fact that it was completely new with no cost experience available was one aspect of the uncertainty. The other, and perhaps more serious, problems arose out of the sharp increase in the general price level in later months, which showed no sign of tapering off.

The consideration of price and its effect on the market potential raised the basic policy question of whether the company should attempt to take a high profit margin on a relatively small volume of sales or accept a low and somewhat precarious profit margin in the hope of building a large long-run market for their product. After much thought it was firmly decided to plan for a modest unit profit in the hope of a large and continuing volume of sales.

To test market acceptance and estimates as to customer interest, arrangements were made with a local department store to let the Hales display one of the production models and take orders at a tentative price. The test sales met with a gratifying response. It became apparent, however, that even at the lowest feasible price the product would require aggressive "point-of-purchase" sales effort. The tool might "sell itself" in a few cases, but demonstration by trained personnel seemed essential to large sales.

The next marketing question facing Mr. Hale was that of selection of channels of distribution. Obvious possibilities were sale through regional chain stores, such as the Western Auto Supply stores, or through large mail-order houses, such as Sears, Roebuck & Company. The mail-order chains had the advantage of national distribution. His preliminary investigations of the market indicated that mail-order catalogue sales would be small and that the demonstration and aggressive selling the product needed could best be obtained through the retail stores maintained by the mail-order house. Each of the largest chains maintained a number of retail outlets, although the coverage of each company was somewhat spotty. As an illustration of the lack of coverage of many metropolitan areas, none of the large chains had a retail store in New

York City or Seattle, Washington. Mr. Hale had heard a lot of controversy over the desirability of selling through the mail-order companies. In his view they could be counted on for very aggressive merchandising, but he knew of their reputation for shrewd and sometimes hard bargaining with their suppliers. On the other hand, their credit was unquestioned, and they would pay approximately 20 days after invoices for material shipped them were received.

The local regional buying offices of two of the principal mail-order houses were contacted. The regional buyers of each company expressed real interest in the product. Each made clear, however, that his company would consider handling the item only on an exclusive basis in the cities in which they had retail outlets. Neither would take it if the other mail-order company also sold Quin-Craft.

Large department stores also represented logical channels of distribution. It was thought that by granting an exclusive franchise to a large department store in each of the major cities of the country, the aggressive selling efforts of these stores could be secured. Sale through department stores would have the advantage of not basing all the company's fortunes on its relationship with a single firm since for the most part the department stores were owned and operated as independent units. On the other hand, to contact and sell the widespread department stores would require a much larger sales organization and much more travel expense than would be necessary in dealing with a single mail-order company. Furthermore, a larger inventory might well prove necessary in order to meet promptly the orders of many department stores, and the collection period on accounts receivable would probably average 40 days.

In planning a sales program Mr. Hale was conscious of a degree of time pressure. It seemed essential to get the product on the market and established during a period of economic prosperity such as currently prevailed. Also, it seemed highly advantageous to get the initial impetus to sales that would be provided by getting the product on the market in time for the 1947 Christmas selling season.

While Mr. Stuart Hale was considering marketing possibilities, Mr. Tom Hale was concerned with the problem of how best to produce the tool. An initial question was: Should Supra Development Corporation attempt to manufacture the Quin-Craft or should it have other companies make it? It appeared clearly desirable for Supra to purchase some component parts such as castings and the $\frac{1}{4}$ hp electric motor which

provided the power for the tool and saw blades. Consequently, the problem resolved itself into one of complete subcontracting of production and assembly or of production of simpler parts and assembly by the company. Assembly by the Hales would mean that a plant would have to be leased or purchased. Some machinery and other plant equipment would have to be bought. Mr. Tom Hale talked with some industrial real estate agents and discovered a plant, roughly adequate for at least the first months' probable requirements, that could be purchased for what appeared to be a very reasonable price of $100,000. However, some alterations in the building would be desirable. They would cost around $20,000. If operations were restricted to assembly, the necessary equipment could be purchased for between $20,000 and $30,000. It was thought that adequate labor and supervisory personnel could be recruited.

Mr. Hale had talked to officials of several local concerns about the possibility of their handling production and assembly on a contract basis. Several indicated that they had all the work they could handle at present; but officials of a large ship repair company, Gulf Coast Marine Repair, Inc., expressed serious interest. Officials explained that they had considerable excess capacity and were considering use of their facilities for other than marine repair work. They reviewed the plans carefully and expressed the conviction that they could produce the Quin-Craft for what the Hales regarded as a reasonable price. They would require, however, that Supra pay for certain tools that Gulf Coast would need to be able to make the Quin-Craft. Estimated cost of these was between $6,000 and $10,000. Also, general shortage of many basic raw materials for the Quin-Craft had been developing since the war; and the ship repair company stated that the Hales would have to provide the necessary raw materials and components, such as the electric motor, to be purchased outside. Despite the general steel shortage, however, the supply of bar steel and pig iron for castings which would be used in the Quin-Craft was not yet critical.

Subcontracting promised substantial advantages from a time standpoint since the ship repair firm estimated that they could be ready for quantity production by November 1, 1947. After talking to friends in production jobs, Mr. Hale concluded that it would take Supra at least until January 1 to set up its own production organization and facilities.

It was at this stage of the development of the project that Mr. Stuart Hale decided to focus attention on the financial aspects of the plans.

Both he and his brother until this date had rather assumed that the financial aspects could be worked out satisfactorily after production and marketing plans had been made. Mr. Stuart Hale had no experience in finance beyond classroom work in school. When he sat down to estimate the financial requirements for the program, he was somewhat dismayed at the size of the possible financial need and the wide range in amounts needed under the various alternative programs of manufacture and sale.

The amount required for investment in fixed assets obviously would be greatly influenced by the decision as to subcontracting. If the company bought its own plant the need for funds was sharply increased. Regardless of how much the company subcontracted, some \$6,000 would be required for transportation and office equipment. It was estimated that \$8,000 would have been spent in the development of the product and at least \$3,000 in preliminary marketing expense. It would cost around \$500 to organize the new corporation. In addition it would be necessary to recruit a secretary in the near future and to hire a shipping clerk, a bookkeeper, and other office help before sales began. For the present neither of the Hales planned to draw a salary.

The amount of money required for working capital also appeared to be very much dependent upon the choice of marketing and production arrangements. Some investment in inventory would be required under any plan. In addition, an investment in accounts receivable could be avoided only if the company were to sell for cash. Also the company would have to carry some cash in a bank account so as to have cash available in the event of emergencies, such as strikes or shipping tie-ups.

Under any of the alternative production arrangements, some inventory would have to be maintained at the expense of Supra. If the production job were contracted, it was expected that Supra would provide only accessories such as the electric motor. In order not to delay work by the contractors a supply of these accessories would have to be maintained at the plant. In view of the possibilities of subcontractor strikes, material shortages, and other interruptions to continuous flow of accessories, it seemed desirable from a production standpoint to carry a stock of as much as a month's supply of these accessories. Although at this time estimating the unit cost of the accessories and the volume of production was difficult and vague, Stuart Hale was thinking in terms of a volume of 900 units a month in the first months and a unit cost of about \$30 for accessories (including the relatively expensive electric motor). Under subcontracting arrangements an investment in other raw mate-

rial and in work in process would be avoided. If Supra Development Corporation undertook to produce Quin-Craft itself, an additional investment in raw materials, perhaps $10 a unit, would be required. It was expected that the production and assembly process would take about 10 days.

Under any production arrangement some inventory of finished Quin-Crafts would ultimately be required if the company were to furnish prompt shipment as orders were received. For the first few months, however, under the ideal distribution setup, orders would exceed production and hence an investment in finished goods inventory would be limited to one or two days' production in process of inspection and shipment. Total manufacturing cost of finished Quin-Crafts at present price levels promised to be between $75 and $85 a unit without motor. The motor would add an additional $20–$30 in cost.

The required investment in accounts receivable would vary with the terms that could be worked out with distributors selected; but Mr. Hale tended to think in terms of an average of one month's sales on the company's books at any one time, if sales were made through a mail-order house, and about 40 days if sales were made to scattered retailers. At the end of the first month of sales, however, receivables would equal one month's sales under any of the plans.

In an effort to translate his ideas into some sort of estimate of the investment needed, Mr. Hale brought them together in the form shown in Exhibit 1 (p. 330). He chose to picture the investment that might be required after about one month of full operations. He chose this date since he felt this would likely be the time of greatest "strain" financially. At this time commitments would be great and proceeds of sales would not yet have been received.

His estimates of accounts payable and accrued expenses were particularly rough and were based on the hope that the company could get about one month's trade credit from both the suppliers of accessories or raw materials and the contractor, if one were used. In preliminary discussions with the Gulf Coast Marine Repair Co., no mention had been made of credit terms, but he felt that credit could be arranged if the Supra Development Corporation could present a reasonably "healthy" financial statement.

Since his figures were at best uncertain estimates, Mr. Stuart Hale drew up maximum and minimum estimates under the two major sets of assumptions indicated in the exhibit. Actually, these did not represent

full ranges of what might be required, but he thought they were sufficient for the purpose of seeing in very rough terms the amount of funds to be raised to finance operations under the major alternatives.

His estimate of 900 units produced and sold in the first month was obviously not a precise one. He realized that, to the extent that actual production and sales experience proved different from his estimates, capital requirements would be altered. Further, if prices should continue to rise, the estimates would have to be revised upward. As plans became more definite, Mr. Hale expected to be able to sharpen his estimates and perhaps to make up some cash budgets based on fairly definite plans.

The next major financial question was how best to meet the possible financial needs. Mr. Schneider had no personal resources and under the original agreement was entitled to one-third ownership of the company in return for his invention. Mr. Stuart Hale had some $14,000 in savings which he had accumulated, most of which was currently invested in readily marketable stocks and in war bonds. Mr. Tom Hale had recently used all of his savings to purchase a home in a near-by suburb. However, it was owned outright and could be mortgaged for about $15,000. The costs of development to date, together with Mr. Schneider's salary, had been met from the Hales' savings. The Hales' parents expressed a willingness to invest as much as $20,000 of their savings in the concern on a temporary basis. However, both of the sons realized that their venture, like most new businesses, was a risky one. Consequently, they hesitated to commit resources of their parents, which had been accumulated as security for their old age, to the enterprise.

Mr. Stuart Hale had given some thought to possible sale of preferred or common stock. Among his friends were some men of considerable wealth, who, he felt, would buy stock in the new concern. However, any common stock sold would have to be out of the two-thirds allocated to the Hales. This would reduce their control over the company and would limit the return.

Stuart Hale knew of a few new concerns which had been able to sell small amounts of preferred stock. This stock could carry a fixed dividend rate of 6% or 7% and seemed a possible answer to the problem of raising funds. However, upon investigation he found that his friends were interested in investing in his venture only on a common stock basis. They argued that preferred stock offered almost as much risk in situations of this sort as the common without the possibilities of large return if the company succeeded. From his preliminary discussions, Mr. Hale

Exhibit 1

SUPRA DEVELOPMENT CORPORATION

PRO FORMA BALANCE SHEET AFTER ONE MONTH OF OPERATION

(Dollar figures in thousands)

	Assuming Production by Supra in Own Plant and Development of Independent Sales System Using Department Stores, Sales of 900 Units at $125		Assuming Subcontracting of Production and Assembly, Sale through Mail-Order Chain, Sales of 900 Units at $125	
	Minimum	Maximum	Minimum	Maximum
Current assets:				
Cash	$ 15	$ 20	$ 10	$ 15
Inventory:				
Raw material	9	12	...	...
Accessories and supplies	20	30	14	27
Goods in process	10	15	...	...
Finished	7	36	7	10
	$ 46	$ 93	$ 31	$ 37
Accounts receivable	112	112	112	112
Total current assets	$173	$225	$143	$164
Fixed assets:				
Plant	100	120	...	...
Plant equipment	20	50	6	10
Office and transportation equipment	6	12	6	8
Development expense:				
Marketing	10	15	6	8
Administration	12	15	6	8
Organization	1	1	1	1
Patents	?	?	?	?
Total assets	$322	$438	$168	$199
Liabilities:				
Accounts payable and accrued expenses	$ 80	$120	$ 90	$ 99
To be raised	242	318	78	100
Total liabilities	$322	$438	$168	$199

concluded that preferred stock could be sold only if a substantial block of common were offered to the purchasers of the preferred stock. Furthermore, registration of stock with the state authorities often required several weeks' time and considerable paper work. He also considered the possibility of issuing bonds but it appeared that it would be hard to interest investors in the bonds of a new and small company. However, if the plant were purchased it was thought that a mortgage of at least $50,000 could be secured against the plant.

At this stage, Mr. Hale visited a friend who was a vice-president of the Texas National Trust and Savings Association, a bank which had the reputation of being progressive and of encouraging new companies. Mr. Clark, the banker, listened to Mr. Hale's plans with interest. Mr. Clark explained that the bank had to be very careful about loaning to new unproved companies. In some cases, however, the bank had advanced funds for a portion of the working capital requirements of new concerns provided they had careful and complete plans by which they could demonstrate an ability to repay the loans in a relatively few months.

Buckeye Mold & Tool Company

In January, 1947, the management of Buckeye Mold & Tool Company was faced with the problem of formulating a financial program for the current year.

Buckeye Mold & Tool Company was incorporated in January, 1945, by Jack Chase and Elmer Sorenson, toolmakers in the mold department of the Akron Rubber Company. Molds were used to form specialty rubber products, such as toys, industrial parts, fountain pens, hot-water bottles, and a variety of other items. The life of a mold depended upon the simplicity of its design and the tolerances specified for the part that was to be molded. A mold for a simple part might last through three or four months, whereas an intricate mold might have to be discarded after two or three weeks of use. Throughout the war there was an inadequate supply of rubber molds because of the shortage of skilled labor. It required many years of training to produce a qualified mold maker.

The Akron Rubber Company, in common with most other specialty rubber companies, operated its own mold department. In times of normal or peak demand, however, part of its requirements was obtained from independent mold and tool companies.

Jack Chase had noted the high prices and the poor quality of the molds supplied his company during the war. He was convinced that if he could raise enough capital to start a small plant he would have no difficulty in getting a profitable volume of orders. In January, 1945, Chase and his brother-in-law, Sorenson, pooled their savings of $7,500 and formed Buckeye Mold & Tool Company.

The company started operation in the basement workshop of Sorenson's home, which was located in Pleasantville, Ohio, about 20 miles from Akron. As Chase had anticipated, no difficulty was experienced in obtaining orders. The company started with four customers, each a large manufacturer with a high credit rating. About $6,000 of the initial capital was invested in secondhand machinery. Materials and supplies were

purchased in small quantities as they were needed. All the labor was performed by Chase and Sorenson, with the assistance of the latter's 18-year-old son, an able machinist. Chase's wife attended to the office work and bookkeeping.

The company soon found itself in need of additional capital to finance inventory and to pay for small tools and heat treating. In May, 1945, $2,000 was borrowed from Chase's mother, with the promise that the money would be repaid at the earliest opportunity.

In the summer of 1945 it became apparent that additional financing was needed. The basement workshop was proving inadequate for the volume of business that could be handled. In August an arrangement was negotiated with the Pleasantville Trust Company whereby the latter agreed to lend the company $10,000 on 90-day, 6% notes secured by a chattel mortgage on machinery and second mortgages on Chase's and Sorenson's homes. Later that month $15,000 was spent on the purchase of a small building into which the machinery was moved. A $7,400, 5%, 5-year mortgage on the building was arranged with the Pleasantville Savings and Loan Association. After moving to the new building, several machinists were added to the payroll. The new employees were carefully selected from among the best men with whom Chase and Sorenson had worked in the past.

New machinery and employees were added from time to time. The purchases of the new machinery were financed with the aid of loans from the Pleasantville Trust Company secured by chattel mortgages. By November, 1945, the company owed the bank $20,000. In that month, Jack Chase, who handled administrative matters, was introduced by Mr. Leib, loan officer of the Pleasantville Trust Company, to Mr. Phillips, a vice-president of the Mammoth National Bank of Cleveland. In the course of their conversation Mr. Phillips indicated that as a "starter" his bank would be willing to lend the company up to $5,000 on notes secured by chattel mortgages. Chase had, however, no immediate need for such a loan.

The company's first year proved profitable. Earnings before income taxes were $19,580 on sales of about $38,000. See Exhibits 1 and 2 for financial statements. The company had acquired 10 customers, all major concerns, which were ready to supply the firm with all the orders it could handle. Buckeye Mold & Tool had won a reputation in the trade for high-quality workmanship.

The company continued to grow during its second year. A $3,000, 6%, 90-day note for the purpose of purchasing machinery was placed

with the Mammoth National Bank in February, 1946. At the time the loan was made, Mr. Phillips offered the firm a line of $25,000 to be secured by pledge of the accounts receivable. Interest was to be at the rate of 5%, plus a service charge of 2%. Advantage was not taken of this offer. Instead, as sales and profits increased, Chase was able to borrow additional money from the Mammoth bank on the same 6%, 90-day terms as the original $3,000 loan. In February, 1946, the notes held by the two banks, which had reached a total of $43,000, were combined into a single note secured by a blanket chattel mortgage on the machinery. It was understood that the Mammoth National Bank held a 50% participation in the new note. The second mortgages held by the Pleasantville Trust Company on Chase's and Sorenson's homes were relinquished.

In the three months from August to November, 1946, the company repaid $12,000 to the banks and the $2,000 borrowed from Chase's mother. In November an additional $4,000 was borrowed from the Pleasantville Trust Company on a 90-day note, secured by a chattel mortgage, for the purpose of purchasing machinery. Chase negotiated this note at a 5½% interest rate on the strength of the company's improved financial condition.

In the fall of 1946 Chase persuaded Sorenson that it would be profitable to take orders for mold frames. Frames were used to hold molds in the press during the molding process. A frame would last about six months and did not require highly skilled workmanship. Plans were made for enlarging the company's plant to handle frame production. Late in December, however, the Pleasantville zoning board ruled against permitting the proposed construction.

In January, 1947, Chase approached Mr. Leib with plans calling for the purchase of a suitable plant which had just become available, the building and land to cost $60,000. Chase also wanted to spend $40,000 on new machinery to be used for expanding mold production and for the manufacture of frames. He asked Mr. Leib if his bank would be willing to finance these purchases and, in addition, grant a $50,000 line of credit for working capital purposes. Mr. Leib stated that the Pleasantville bank could not make so large a commitment but that he would discuss the proposal with Mr. Phillips. Several days later Mr. Leib and Mr. Phillips called on Chase. Mr. Phillips expressed satisfaction with the company's progress but cautioned against a disproportionately large investment in fixed assets, especially if financed by borrowing. Mr. Phillips stated that his bank was willing to continue to renew its portion of

the note and to lend additional funds for working capital needs and essential additions to plant and equipment. He did not, however, believe that it would be advisable for the bank to lend money for the purchase of a new plant or for expansion into the frame business.

Following his conversation with Mr. Phillips, Chase discussed his plans with Mr. Weil, Cleveland branch manager of the Acme-National Credit Corporation, a finance company. Mr. Weil expressed interest and stated that his company might be willing to finance the program. Mr. Weil said that it would probably be possible to work out a 6%, $40,000 mortgage on the new building, to be repayable in 10 annual installments. In addition he would consider a revolving loan to be secured by pledge of the receivables. The revolving loan would be at 6% rate of interest plus a 3% service charge. Additional needs could be financed by 8% notes secured by chattel mortgages on machinery in an amount equal to a maximum of 80% of the purchase price, by assignment of the inventory and by second mortgages on the partners' homes.

Chase also approached the Pleasantville Savings and Loan Association, which expressed interest in taking a $35,000, 5½% mortgage on the proposed new building, the loan to be amortized in 15 years.

Chase and Sorenson were debating the advisability of going through with their expansion plans when they received their statements for the year ending December 31, 1946. (See Exhibits 1 and 2.) Sales in the last quarter had averaged $25,000 a month, and had been distributed among 15 accounts.

To assist himself and Sorenson in formulating financial plans for the coming year, Chase prepared several estimates. If they remained in their current building, he estimated that sales for 1947 would total around $325,000 and profits before income taxes, $120,000. Under current laws, federal income taxes for corporations earning over $50,000 would be at the rate of 38%. If the proposed plant and machinery purchases were made and the manufacture of mold frames undertaken, Chase estimated that sales for the year would total $600,000 and profits would be $210,000 before income taxes. Estimates of sales and profits were based on the assumption that demand for molds and frames would continue at about the current rate.

Selling terms on frames would be the same as for molds, net/30 days. It was estimated that raw materials inventory would double if the proposed expansion were undertaken, while work in process would be related to sales volume in about the same ratio as currently. It was thought that the building and land owned could be sold for $20,000.

Exhibit 1

BUCKEYE MOLD & TOOL COMPANY

BALANCE SHEETS

ASSETS

	Dec. 31 1945	Dec. 31 1946
Cash	$ 504	$ 151
Accounts receivable	2,042	37,740
Inventory:		
Raw	656	2,040
In process	11,012	30,454
Prepaid expenses	465	12,606
Total current assets	$14,679	$ 82,991
Fixed assets:		
Machinery and equipment	.....	$ 73,680
Less: Reserve for depreciation	.....	4,740
Net	.....	$ 68,940
Buildings	.....	15,300
Less: Reserve for depreciation	.....	770
Net	.....	$ 14,530
Land	.....	11,515
Other assets	.....	2,367
Total fixed assets	42,897	$ 97,352
Total assets	$57,576	$180,343

LIABILITIES AND CAPITAL

	Dec. 31 1945	Dec. 31 1946
Accounts payable	$ 359	$ 834
Accrued expenses	3,237	4,746
Notes payable	19,500	35,000
Reserve for taxes	5,275	43,275
Accrued interest	.....	282
Accrued wages	.....	2,386
Total current liabilities	$28,371	$ 86,523
Mortgages	7,400	6,200
Capital stock	7,500	7,500
Surplus	14,305	80,120
Total liabilities and capital	$57,576	$180,343

Exhibit 2

BUCKEYE MOLD & TOOL COMPANY

INCOME STATEMENTS

	1945	1946
Sales	$38,000	$256,220
Cost of sales	14,330	124,947
Depreciation	1,430	4,300
Gross profit	$22,240	$126,973
Selling and administrative expenses	2,660	19,576
Net profit from operations	$19,580	$107,397
Other expenses	.....	1,453
Federal income taxes	5,275	40,400
Net profit	$14,305	$ 65,544

Cambridge Metal Products, Inc.

In November, 1944, the officers of Cambridge Metal Products, Inc., were studying possible methods of financing the purchase of Precision Forgings Company, a transaction currently under consideration.

Cambridge Metal Products, Inc., manufactured metal specialties. Its products prior to World War II consisted of accessories for automobile bodies and interiors. About 80% of dollar sales in peacetime were made direct to automobile manufacturers and the remainder to jobbers and large retailers. Four principal customers normally accounted for nearly 40% of volume, with different divisions of large manufacturing companies constituting separate purchasers. The automobile accessories business was highly competitive, with competition coming from automobile manufacturers themselves as well as from suppliers. Nevertheless, in the nine-year period from its reorganization in 1933 through 1941, Cambridge Metal Products' sales had increased 600%.

Prior to its reorganization Cambridge Metal Products, Inc., had been controlled by Mammoth Machinery Corp., a large concern engaged in the manufacture of industrial machinery. Cambridge Metal Products, Inc., had had an indifferent record until the depression, when substantial losses forced it into bankruptcy and wiped out its stockholders' equity.

Active in the reorganization proceedings were several partners in Vassall and Company, an old-established firm of investment bankers which specialized in the underwriting of municipal bonds and high-grade industrial securities. These men, who were friends of Alan Curtis, president of Cambridge Metal Products, Inc., invested a moderate sum of their personal money in a block of the reorganized company's stock. Due to their persuasion, Samuel Prescott, director and officer of a number of concerns, also invested some money in the company and accepted the position of vice-president. Amos Breed, a director of several organizations in which Vassall and Company had interests, was appointed

treasurer. Mr. Prescott and Mr. Breed devoted only part of their time to Cambridge Metal Products, Inc. The routine duties of the treasurer's office were performed by an assistant selected by Mr. Breed.

Mr. Curtis, an able salesman with valuable contacts in the automobile industry, was retained as president. A large share of responsibility for management was given, however, to Howard Putnam, an energetic young engineer who had resigned his position with a large automobile manufacturer to go with the company as assistant production manager in 1930. Following the reorganization, Mr. Putnam thoroughly revised the company's managerial personnel and policies and modernized its plant and equipment, while Mr. Curtis concentrated on selling and on managing the sales department. Mr. Putnam frequently called on Mr. Prescott and Mr. Breed for advice on financial and other matters. Both had a wealth of business experience, much of it gained in helping concerns which were in financial difficulties.

Thanks to the combined efforts of these men, sales and profits, which had been lagging behind the rest of the automobile accessories industry, began to show marked increases (see Exhibit 1 [p. 343]). The company's financial condition improved sufficiently to allow dividend payments of 45 cents a share in 1936, 60 cents annually from 1937 through 1939, and 90 cents thereafter.

Early in 1941 Mr. Curtis retired and his son was placed in charge of sales. Howard Putnam succeeded to the presidency. The principal effect of these changes was that Mr. Putnam devoted more of his time to the sales department and took a greater interest in product design.

Following the cessation of civilian automobile manufacture in 1941, Cambridge Metal Products, Inc., devoted itself exclusively to war production. Part of its wartime output consisted of accessories for military vehicles, and the rest consisted of various metal parts and assemblies. War production necessitated no significant change in plant, equipment, or methods of manufacture. Such special machinery and equipment as were required were supplied by the purchaser without capital expenditure by Cambridge Metal Products, Inc. Output was increased chiefly through lengthening the workweek and through two-shift operation. Wartime working capital needs were supplied by increased earnings and by advances from government agencies and prime contractors. See Exhibit 2 for 1944 balance sheet.

In 1942 the production of plastic rods and bars was started as a means of stabilizing earnings by diversifying output. Selling efforts were

directed to jobbers in the Boston area. Plastics volume in 1944 was $350,000. A research department was created in 1943 for the purpose of developing new products. At the end of 1944 developmental work was being completed on a two-wheel trailer-wagon designed for farm use.

Early in October, 1944, Mr. Prescott was visited by William Howe, a vice-president of the Milk Street Bank and Trust Company of Boston, an institution with which the company had had no previous dealings. Mr. Howe had come to offer for sale 95% of the capital stock of Precision Forgings Company, one of his bank's depositors. Mr. Howe, a director of Precision Forgings Company, represented a group consisting of stockholding officers of the company and the Milk Street Bank as trustee for several estates which owned about 85% of the capital stock.

Precision Forgings Company, located in Watertown, Massachusetts, manufactured high-grade forgings. About 90% of its volume consisted of parts for steam and Diesel locomotives and the remaining 10% of automobile parts. A large proportion of the company's locomotive parts sales, especially in times of depression, were made direct to the railroads for repair and replacement.

By reason of superior technical skill, Precision Forgings Company held a dominant position among its competitors. During the preceding decade, however, the company had not experienced the growth of which, in Mr. Howe's opinion, it was capable. Failure to live up to potentialities was attributed by Mr. Howe to the protracted illness of the president, James Warren. Mr. Howe also thought that majority ownership of its stock by estates had had a restrictive influence on company policy, encouraging management to concentrate on the earning of current dividends to the neglect of long-term growth.

It was the opinion of Mr. Howe and the officers of Precision Forgings Company that affiliation with an aggressively managed concern would furnish the impetus their organization lacked, whereas continued absence of able direction at top levels would eventually lead to a long-term decline. From his knowledge of its accomplishments, Mr. Howe was confident that the management of Cambridge Metal Products, Inc., was capable of supplying the energy and direction that Precision Forgings Company needed.

After listening to Mr. Howe and studying Precision Forgings Company's balance sheet and summary of earnings (see Exhibits 3 and 4), Mr. Prescott inquired about price. Mr. Howe replied that the holders he

represented would sell to the right buyer for $120 a share. The remaining 5% of the stock was distributed among some 25 individuals, most of whom, he thought, could be persuaded to sell at about the same price.

Mr. Prescott surmised from the conversation that, by "the right buyer," Mr. Howe meant someone who would continue to operate the business after the sale and who would give the current management an opportunity to remain with the organization.

Having conveyed the group's proposal, Mr. Howe added that his bank would be willing to arrange a term loan to finance the transaction. Although the bank would not be prepared to take the whole of such a loan itself, he was confident that the Cordwainers Society for Insurance on Lives would be interested in taking part of it. The current annual interest rate for comparable loans was about 4% for maturities of up to five years, and 4½% for maturities of from five to ten years.

Following Mr. Howe's visit, Mr. Prescott made a study of Precision Forgings Company. He learned that its management below top levels was considered good, and that most of its officers were competent, although none was outstanding. Mr. Prescott called on a number of railroad purchasing agents and found that the company enjoyed an excellent reputation based both on fair dealing and the high quality of its product. Unusual confidence was expressed in its technical staff, generally considered the best in the industry. Mr. Prescott also ascertained that foreseeable changes in locomotive design would not be likely to eliminate the need for high-quality forgings. Inquiries were made about the plant, and it was learned that it was kept in good repair. A large proportion of the company's machinery was thought to be over 15 years old but was evidently in good operating condition. The plant had not undergone any wartime conversion because the same products were being produced as in peacetime. Mr. Prescott also learned that there had been a shortage of unskilled labor since the war and that for that reason the plant was currently operating at less than three-fourths of capacity.

Having satisfied himself that the proposal merited consideration, Mr. Prescott discussed it with Amos Breed, the treasurer. The latter agreed that Precision Forgings Company appeared to be an attractive "buy" at $120 a share and that the company would benefit greatly from Mr. Putnam's direction. Mr. Breed pointed out that the purchase would be in accordance with the policy of stabilizing earnings by diversifying sales. He added that, in his opinion, the combined companies would be large enough to sell securities to the public on a favorable basis as a means of financing the purchase.

Following their discussion, Mr. Prescott and Mr. Breed presented Mr. Howe's proposal to Howard Putnam. The latter's reaction was mixed. He admitted that it seemed like a good buy, but he had a number of reservations as to the purchase.

For one thing, Mr. Putnam suspected that purchase of Precision Forgings Company might absorb so much of Cambridge Metal Products' financial resources as to prove an obstacle to establishing a plant in the Midwest, which he had for some time thought of as possibly being desirable. New England, he felt, was not keeping pace with the industrial growth of the nation. Moreover, Boston was far removed from the center of the automobile industry; the majority of the company's competitors and customers were located in the Midwest. In the discussions at board meetings, Mr. Putnam had stated that one advantage of a branch plant in the Great Lakes area would be a reduction of shipping costs and time. He believed that a Midwest plant, if it were acquired, should be used to produce accessories for the automobile industry, while the Cambridge plant would be devoted to plastics and new products. Mr. Putnam anticipated that, at the end of the war, defense plants and machine tools would become available for purchase on favorable terms. He estimated that the new plant would call for an expenditure of from $300,000 to $350,000.

He also expressed concern about the possibility of a term loan because of the covenants which the insurance company would probably try to impose. These provisions usually restricted a company's right to purchase property and to borrow money. Furthermore, he had reservations about a public issue of securities. Mr. Putnam had invested and was continuing to invest the greater portion of his personal funds in Cambridge Metal Products' shares. The shares were closely held and seldom traded, though blocks of stock became available from time to time. The directors had voted to sell treasury stock to Mr. Putnam at current book value on several occasions when he had been unable to buy any through his brokers. Over the years Mr. Putnam had accumulated a 15% interest in the company, and he did not wish to see his interests as a stockholder damaged or his dividends reduced.

Lastly, Mr. Putnam was worried about the long-run financial effect on the company of a purchase of this size. Precision Forgings Company was larger than Cambridge Metal Products, Inc., and he recalled several instances in which prosperous concerns had gotten into difficulty through less ambitious expansion.

Despite his misgivings, Mr. Putnam expressed confidence in the

judgment of Mr. Prescott and Mr. Breed, especially in financial matters, and he terminated the conference with a request that Mr. Prescott investigate the feasibility of financing the purchase through a public issue of securities.

A week later Mr. Prescott reported to Mr. Putnam that he had discussed informally with several investment bankers the possibility of a public flotation and that a public issue of securities appeared feasible. Consequently, he had prepared a memorandum which presented in outline three programs for raising the funds for the purchase. The programs were based on the assumption that Cambridge Metal could secure an option to buy 12,255 shares of Precision Forgings stock before it entered into any program of security issue. After discussion with the company's lawyers, Mr. Prescott also assumed that, if the purchase of stock were consummated, the two companies would be merged as soon as possible and the Precision Forgings stock retired. The lawyers advised that a statutory merger of the type Mr. Prescott contemplated was possible under the laws of Massachusetts, in which state each of the companies was incorporated. Such a merger, however, required the approval of two-thirds of the stockholders of each company. It was believed that there would be little or no difficulty in gaining the necessary approval of Cambridge Metal stockholders; and, since Cambridge Metal would own 95% of the Precision Forgings stock, approval on the part of Precision Forgings was assured. Under the laws of Massachusetts dissenting stockholders of either company who voted against the merger were entitled to receive payment in cash for the value of their stock on the day of the merger. In the event the corporation and a dissenting stockholder were unable to agree on the value to be placed on the stock, such value was to be ascertained by three disinterested persons, one of whom was to be designated by the stockholder, one by the corporation, and the third by the two thus chosen. Mr. Prescott believed that few Cambridge Metal stockholders would object to the merger and demand payment for their shares.

In view of Mr. Putnam's concern about the size of the purchase, Mr. Prescott had reviewed the balance sheets of both companies with Mr. Breed. They agreed that the company after merger could operate with less cash than the combined cash accounts of the two companies on Sepetmber 30. They also questioned the need for continuance of the life insurance carried by Precision Forgings. After considerable study they decided to recommend that Cambridge Metal plan to convert its $30,000 in government bonds into cash and then utilize $250,000 of

cash from the company treasury for the stock purchase. After the merger the company would, according to their recommendations, liquidate the $110,000 life insurance policy now carried by Precision Forgings. With the cash Precision Forgings now had, the cash on hand would then be adequate for the needs of the company after the merger. Thus, under these plans, for purchase of the entire 12,900 shares of Precision Forgings stock at $120 a share a total of $1,548,000 would be required and Cambridge Metal Products, Inc., should plan to raise approximately $1,300,000.

The three plans for raising the $1,300,000 that Mr. Prescott felt most worthy of consideration were:

1. Creation of a new issue of 5% cumulative, nonvoting preferred stock and sale of 13,000 shares to net $100 per share to the company. The stock would be callable at the option of the company at 105.
2. Arrangement of a 4½% term loan for $1,300,000, with repayment to be scheduled in equal installments over a 10-year period.
3. Sale of 130,000 shares of $1.00 par common stock at $10 per share net to the company.[1]

Exhibit 1

CAMBRIDGE METAL PRODUCTS, INC.

SUMMARY OF EARNINGS

(Dollar figures in thousands)

	Net Sales	Cost of Sales	Net Profit before Taxes	Net Profit after Taxes
1933	$ 244	$ 237	$ 82[d]	$ 82[d]
1934	457	388	10[d]	10[d]
1935	806	605	106	86
1936	763	551	94	82
1937	1,266	899	154	117
1938	893	674	37	31
1939	1,490	1,031	234	191
1940	2,419	1,662	148	110
1941	2,446	1,975	210	139
1942	5,212	4,650	735	200
1943	6,859	5,749	724	222
1944*	7,100	5,900	750	240

* Estimated.
[d] Loss.

From his talks with the bankers Mr. Prescott was convinced that the prices and terms of the issues were reasonable under present market conditions. He also stated that each of the bankers had assured him that the new common stock could be widely distributed, with limits on the amount sold to any one individual.

[1] On November 25, 1944, the over-the-counter quotation (bid) for Cambridge Metal Products, Inc., stock was $11.50 per share.

Exhibit 2

CAMBRIDGE METAL PRODUCTS, INC.

BALANCE SHEET ON SEPTEMBER 30, 1944
(Dollar figures in thousands)

ASSETS

Current assets:	
Cash	$ 244
U.S. government securities	30
Accounts receivable	293
Inventory	321
Total current assets	$ 888
Plant and equipment	$ 445
Less: Allowance for depreciation	181
Balance	$ 264
Deferred charges	16
Cash surrender value of life insurance	7
Claims for refunds on federal taxes	127
Miscellaneous	....
Total assets	$1,302

LIABILITIES AND CAPITAL

Current liabilities:	
Accounts payable	$ 230
Accrued liabilities	66
Provision for federal income taxes	323
Total current liabilities	$ 619
Capital:	
Common stock outstanding, $1.00 par value	$ 95
Earned surplus	588
Total capital	$ 683
Total liabilities and capital	$1,302

Exhibit 3

PRECISION FORGINGS COMPANY

SUMMARY OF EARNINGS
(Dollar figures in thousands)

	Net Sales	*Cost of Sales*	*Net Profit before Taxes*	*Net Profit after Taxes*
1935	$1,614	$1,078	$184	$159
1936	2,163	1,349	413	356
1937	2,349	1,618	333	271
1938	1,324	999	40	35
1939	1,841	1,360	148	120
1940	1,990	1,532	120	94
1941	3,849	2,717	326	220
1942	4,000	3,296	274	160
1943	3,862	3,130	228	94
1944*	4,200	3,450	392	222

* Estimated.

Exhibit 4

PRECISION FORGINGS COMPANY

BALANCE SHEET ON SEPTEMBER 30, 1944

(Dollar figures in thousands)

ASSETS

Current assets:	
Cash	$ 353
U.S. government securities	150
Accounts receivable	630
Inventory	849
Total current assets	$1,982
Plant and equipment	$1,945
Less: Allowance for depreciation	786
Balance	$1,159
Deferred charges	68
Cash surrender value of life insurance	111
Claims for refunds of federal taxes	86
Total assets	$3,406

LIABILITIES AND CAPITAL

Current liabilities:	
Accounts payable	$ 76
Accrued liabilities	95
Provision for federal income taxes	214
Total current liabilities	$ 385
Reserves:	
For pensions	73
Postwar contingencies	640
Total liabilities	$1,098
Capital:	
Common stock, $100 par	$1,290
Earned surplus	1,018
Total capital	$2,308
Total liabilities and capital	$3,406

PART 5

COMPREHENSIVE PROBLEMS

Mitchel's Store, Inc.

In October, 1947, Mr. Paul Clark, a vice-president of the Standard National Bank in a city in New York State, asked James Leskie, a member of the credit department, to analyze the present financial condition of Mitchel's Store and the trends in its condition as shown by the figures presented in Exhibits 1 through 5. Mr. Leskie accumulated the data shown in Exhibits 6 to 9, from material in the bank's library, because it might aid him in studying the operations of Mitchel's Store.

Mitchel's Store currently had an annual sales volume of about $1,250,000 and was located in a large city west of Albany. Originally, Mitchel's limited its line to home furnishings, which included furniture, draperies, rugs, lamps, records, radios, and pianos. The company had a long record of earnings. In spite of the sharp contraction of high-quality furniture sales during the depression of the 1930's, the company lost money for only two years. Through retention of earnings, the net worth had been steadily increased, although dividends had been paid regularly.

The company, since its inception in 1925, had been operated by David Mitchel, who owned substantially all the capital stock. In 1946, he was 67 years of age. Since 1943, David Mitchel had depended on Mr. J. M. Rogers to a large extent for the management of the store. Mr. Rogers in 1946 was 47 years old, and for some years he had been treasurer of Mitchel's Store. He was well thought of in trade and bank circles.

In the early part of 1946, Mr. Mitchel and Mr. Rogers discussed with Mr. Clark of the Standard National Bank some plans they had developed. Recently there had been a fire that destroyed an office building adjoining Mitchel's Store. This property was owned by the same interests as had leased the store building to Mitchel's. These interests planned the construction of a one-story "taxpayer" building to serve until build-

ing costs declined. Messrs. Mitchel and Rogers felt that it would be wise to lease this new building. They proposed to install there in the next several months a department which would sell toys and sporting goods. It was felt that, inasmuch as Mitchel's was located in a downtown general shopping area, an expansion of this type would be profitable in itself and would bring increased sales of furniture through combined patronage. Mr. Mitchel said that an oral agreement had been reached with the owners to reimburse the costs, amounting to about $35,000, which would be spent by the store to equip the new area and to provide connections with the older store.

Mr. Mitchel and Mr. Rogers estimated that about $275,000 might be absorbed by the program. Part of this sum would go into increased quantities of the older lines of merchandise, about $70,000 into the new lines, and the balance into the equipment. Most of the latter expenditure was expected to be reimbursed by the landlord when the new building was completed. It was proposed that the store would use its own funds to get the program under way, with the bank's advancing funds as needed up to $175,000.

Mr. Clark recommended such a credit to the loan committee of the bank before the appearance of the March, 1946, balance sheet of Mitchel's Store and the accompanying earnings statement. Mr. Rogers had reported that earnings were good and that the company's general position had not changed greatly since the previous March. The loan committee approved Mr. Clark's recommendation.

In July, 1946, Mitchel's Store found it necessary to borrow from the bank. Mr. Rogers told Mr. Clark that the program of expansion was coming along well and that his budgets showed that the maximum of $175,000 for the loan was still a correct estimate. The new store would, he said, be ready for business at the start of the Christmas season.

The initial loan for $55,000 was made July 15, 1946. The whole amount of $175,000 was outstanding by December 1.

During the first week of December, Mr. Mitchel saw Mr. Clark. He said that an additional $45,000 loan would be needed. The new store equipment would cost about $75,000, or twice the estimate; the landlord had denied making any agreement to reimburse part of this expenditure; construction would continue into January; and furniture manufacturers were making much larger shipments than had been hoped for. However, sales for the year ended November 1 were at the

record level of $1,500,000 and earnings were satisfactory. Mr. Mitchel said that the current budget showed that inventories would be reduced by March 31, 1947, so that the outstanding loan at that time would not exceed $85,000.

Unfortunately, the new store building did not get into operation soon enough to take advantage of the Christmas buying season and it was necessary to have one-half price sales of toys and seasonal sport items nearly as soon as the opening. Markdowns of $5,500 were taken on a retail inventory valuation of $85,000 during the first three months of operation, and further markdowns of $4,250 were taken during April and May. Although the sales of furniture in the Christmas season were up to expectations, a policy of drastic order cancellations was instituted early in 1947, as manufacturers continued heavy deliveries.

By the end of February, 1947, the expansion program had been arrested completely and each departmental manager was put on a strict inventory budget, instead of being entirely free of any controls as heretofore. Both Mitchel and Rogers thought this control would bring reduction of the inventory to $275,000 by July 31, 1947. Yet by March 31, 1947, the Standard National Bank had outstanding loans of $265,000 to Mitchel's Store, for, although the program to curtail inventories was inaugurated in earnest in February, it did not show very much effect until May. Furthermore, the furniture department ran into difficulties with its inventory curtailment program because at least 40% of its items were on a quota basis with the manufacturers. The store would lose contact with these suppliers if they did not order their minimum quota, and some cancellations had to be reinstated.

During the summer, Mitchel's Store paid $65,000 on its loan. In the early part of September, Mr. Mitchel came to see Mr. Clark, and said that August sales were about $150,000. However, because of a trucking strike, a week of deliveries had been lost and hence the book figures would only show sales of $97,000. He expressed confidence that the inventory situation was at last under control and proposed that the loan be repaid as follows: September, $30,000; October, $15,000; November, $15,000; December, $15,000; January, $30,000; February, $30,000; and March, $30,000; leaving a balance of $35,000 to be repaid in the next fiscal year. Mr. Mitchel also discussed with Mr. Clark an arrangement he had made with a finance company to purchase all new time sales accounts, with the store's agreeing to repurchase all those that

Exhibit 1

MITCHEL'S STORE, INC.

BALANCE SHEETS

(Dollar figures in thousands)

	Mar. 31 1942	Mar. 31 1943	Mar. 31 1944	Mar. 31 1945	Mar. 31 1946	Mar. 31 1947
ASSETS						
Cash	$ 4	$ 19	$ 12	$ 17	$ 56	$19
Accounts receivable—regular	55	56	65	63	126	222
Accounts receivable—installment	56	44	43	35		
Merchandise—new store (cost)	213	173	194	166	215	43
Other (cost)						348
Total current assets	$328	$292	$314	$281	$397	$632
Fixed assets, less depreciation	20	30	27	37	35	89
Prepaid interest and insurance	7	6	4	2	5	7
Office supplies	2	2	2	2	...	...
Miscellaneous receivables and notes	2	2	6	7	10	11
Treasury stock	42	38	39	41	1	...
Receivables overdue, less reserve	22	32	26	25	16	38
Total assets	$423	$402	$418	$395	$464	$777
LIABILITIES						
Notes payable—banks	$ 75	$ 57	$ 64	...	...	$265
Accounts payable	67	57	60	$ 72	$112	160
Provision for taxes	24	14	16	38	42	26
Accruals	16	21	17	18	47	65
Dividends payable	3	3	3	3	3	3
Total current liabilities	$185	$152	$160	$131	$204	$519
Capital stock	200	200	200	200	169	166
Surplus	38	50	58	64	91	92
Total liabilities	$423	$402	$418	$395	$464	$777

Exhibit 2

MITCHEL'S STORE, INC.

MONTHLY BALANCE SHEETS

LAST DAY OF MONTH

(Dollar figures in thousands)

	April 1947	*May 1947*	*June 1947*	*July 1947*	*Aug. 1947*	*Sept. 1947*
ASSETS						
Cash	$ 3	$ 15	$ 4	$ 4	$ 4	$ 20
Accounts receivable—net	234	238	242	221	210	236
Merchandise—new store (cost)	46	38	35	23	23	23
—other (cost)	362	349	326	310	279	268
Total current assets	$645	$640	$607	$558	$516	$547
Notes receivable	8	8	8	9	...	...
Prepaid items	8	7	7	...	7	6
Fixed assets, less depreciation	90	91	84	83	81	81
Total assets	$751	$746	$706	$650	$604	$634
LIABILITIES						
Accounts payable	$123	$129	$117	$ 75	$ 75	$ 95
Notes payable	270	240	240	240	200	200
Accrued items	58	64	53	47	57	58
Accounts receivable credit balances	25	27	22	24	31	26
Preferred dividend payable	3	3	3	3	3	3
Total current liabilities	$479	$463	$435	$389	$366	$382
Capital stock	166	166	166	166	166	166
Surplus:						
Reserve for inventory loss	14	14	14	14	4	4
Profit or loss—year to date	...	11	1[d]	11[d]	24[d]	10[d]
Earned surplus	92	92	92	92	92	92
Total liabilities	$751	$746	$706	$650	$604	$634
	1946	*1946*	*1946*	*1946*	*1946*	*1946*
Merchandise (at cost)	$245	$259	$268	$265	$290	$312

[d] Deficit.

Exhibit 3

MITCHEL'S STORE, INC.

PROFIT AND LOSS STATEMENTS

(Dollar figures in thousands)

	Years Ending March 31					
	1942	*1943*	*1944*	*1945*	*1946*	*1947*
Net sales	$720	$742	$765	$837	$966	$1,563
Cost of sales	392	417	425	480	558	965
Gross profit	$328	$325	$340	$357	$408	$ 598
Expenses:						
Operating costs	114	117	120	120	135	239
Advertising	18*	21*	16*	18	28	37
Rent	31	33	33	27	20	41
Delivery	24	30	31	34	36	62
General office	17	22	20	26	26	41
Other†	96	93	96	104	107	183
	$300	$316	$316	$329	$352	$ 603
Operating profit	28	9	24	28	56	5[d]
Other income:						
Purchase discounts	11	9	9	9	11	23
Financing charge on installment accounts	7	4	4	4	3	4
Sundry	2	2	2	5	3	3
	$ 20	$ 15	$ 15	$ 18	$ 17	$ 30
Total income	$ 48	$ 24	$ 39	$ 46	$ 73	$ 25

Other charges:						
Loss on sale of fixed assets	8	...	13	7	...	...
Interest paid	1	2	1	1	...	2
	$ 9	$ 2	$ 14	$ 8	...	$ 2
Profit before taxes	39	22	25	38	73	23
Taxes	20	9	10	21	42	15
Net profit for year	$ 19	$ 13	$ 15	$ 17	$ 31	$ 8
Beginning surplus	26	38	50	58	64	91
Surplus adjustments	...	6	...	4	3	...
Dividends	7	7	7	7	7	7
Ending surplus	$ 38	$ 50	$ 58	$ 64	$ 91	$ 92

* In addition to advertising expense charged to operating	26	25	22	....	....	....
† Includes: Bonuses to officers and department heads	26	10	7			

d Deficit.

Exhibit 4

MITCHEL'S STORE, INC.

MONTHLY PROFIT AND LOSS STATEMENTS

(Dollar figures in thousands)

	April 1947	May 1947	June 1947	July 1947	Aug. 1947	Sept. 1947
Net sales	$105	$126	$ 97	$ 95	$ 97	$137
Less: Cost of sales	62	76	65	60	67	81
Gross profit	$ 43	$ 50	$ 32	$ 35	$ 30	$ 56
Less: Operating expenses:						
Direct	44	41	15	16	15	18
General			32	32	31	30
	$ 44	$ 41	$ 47	$ 48	$ 46	$ 48
Operating profit	1[d]	9	15[d]	13[d]	16[d]	8
Add: Other incomes:						
Miscellaneous	...	...	1	1	1	1
Rentals	1	2	1	1	1	4
Purchase discounts	...	...	1	1	1	1
	$ 1	$ 2	$ 3	$ 3	$ 3	$ 6
Net profit for month	$ 0	$ 11	$ 12[d]	$ 10[d]	$ 13[d]	$ 14
	1946	1946	1946	1946	1946	1946
Net sales	$ 99	$124	$131	$103	$109	$134
Less: Cost of sales	58	73	77	62	65	79
Gross profit	$ 41	$ 51	$ 54	$ 41	$ 44	$ 55

[d] Deficit.

Exhibit 5

MITCHEL'S STORE, INC.

ACCOUNTS RECEIVABLES AGING

(Dollar figures in thousands)

	Mar. 31 1942	Mar. 31 1947	Sept. 30 1947
Regular Accounts:			
Three months old or less	$48	$146	$143
Three to five months old	7	21	22
Over five months old	9	13	17
In hands of attorney	..	1	7
	$64	$181	$189
Installment Accounts:			
Accounts not in arrears	$36	$ 37	$ 48
Accounts in arrears:			
Portion due after statement date	13	7	4
Portion due prior statement date	10	7	7
Accounts in hands of attorney	..	1	2
	$59	$ 52	$ 61
Reserve for bad debts	$ 7	$ 11	$ 14

defaulted on their first three payments. This, it was felt, should eventually release $25,000 to $40,000 formerly needed to finance such receivables. If this were done, payments to the Standard National Bank could be accelerated.

On October 1, Mr. Mitchel called Mr. Clark to say that arrangements with the finance company had progressed so satisfactorily that it would be possible to discount at least $35,000 of the existing installment receivables. Thus the store planned to pay the bank $45,000 within the next few days.

Exhibit 6

MITCHEL'S STORE, INC.

Selected Material from Furniture Store Operating Reports Prepared by the National Retail Furniture Association

TYPICAL LARGE RETAIL FURNITURE STORES

(Over $350,000 Sales Volume)

GROSS MARGIN AND TOTAL OPERATING EXPENSE PERCENTAGES, BY SIZE OF CITY

	1945			1946		
*City Size Group**	*No. of Concerns*	*Gross Margin*	*Total Operating Expense*	*No. of Concerns*	*Gross Margin*	*Total Operating Expense*
250,000 to 499,999	25	44.80	35.40	26	40.95	30.99
All large stores	69	44.76	35.30	108	41.14	28.49

* Cities were classified to their population as shown in the 1940 population census.

STATEMENT OF OPERATIONS FOR THE YEARS 1942–1946

(Percentage of net sales)

	1942	*1943*	*1944*	*1945*	*1946*
Gross sales	105.95	105.48	105.27	105.50	106.63
Less: Returns and allowances	5.95	5.48	5.27	5.50	6.63
Net sales	100.00	100.00	100.00	100.00	100.00
Cost of merchandise sold	55.17	54.61	53.46	55.24	58.86
Gross margin on sales	44.83	45.39	46.54	44.76	41.14

Operating expenses:					
Administrative (including buying)	11.37	10.56	11.51	11.72	9.24
Occupancy	6.78	7.02	6.71	6.59	5.04
Advertising	5.34	4.39	4.33	4.33	3.07
Selling	6.27	6.11	6.29	6.22	5.64
Handling	3.89	4.10	3.76	3.54	3.09
Delivery	2.71	2.60	2.40	2.90	2.41
Total operating expenses	36.36	34.78	35.00	35.30	28.49
Net operating profit	8.47	10.61	11.54	9.46	12.65
Other income:					
Cash discounts earned	1.40	1.10	1.15	1.11	1.29
Income from carrying charges	2.08	1.54	1.49	1.12	1.00
Interest earned (on notes and investments)	0.06	0.26	0.23	0.30	0.19
Recoveries on bad accounts	0.27	0.40	0.33	0.23	0.17
Miscellaneous	0.30	0.10	0.13	0.41	0.40
Total other income	4.11	3.40	3.33	3.17	3.05
Total income	12.58	14.01	14.87	12.63	15.70
Other charges:					
Discounts allowed	0.32	0.30	0.28	0.19	0.24
Interest paid (other than mortgage)	0.37	0.23	0.08	0.13	0.12
Provision for bad accounts	0.69	0.59	0.47	0.43	0.33
Loss on repossessions	0.46	0.14	0.13	0.11	0.10
Loss on trade-ins	0.21	0.07	2.96	0.08	0.03
Miscellaneous	1.37	2.27		1.59	3.02
Total other charges	3.42	3.60	3.92	2.53	3.84
Net profit before income taxes	9.16	10.41	10.95	10.10	11.86
Net profit after income taxes	3.04	3.70	4.25	4.22	7.15
Stock turnover	2	2.33	3.1	3.4	3.8

Exhibit 7

MITCHEL'S STORE, INC.

Excerpt from "Retail Sales Trends, 1935–1944," Prepared by Dun & Bradstreet, Inc., for NRDGA, Published November, 1946, Report for ———, New York

UNWEIGHTED INDEXES OF SALES

(Average Annual Sales 1936–1939 = 100)

Year	*All Stores Reporting (24 stores*)*	*Department Stores (4 stores)*	*Furniture Stores (6 stores)*
1935	84.8	82.8	87.4
1936	94.2	93.2	98.4
1937	100.6	99.9	104.4
1938	98.2	98.6	92.4
1939	107.0	108.3	104.8
1940	112.7	114.5	115.7
1941	134.3	137.1	151.7
1942	139.0	142.7	163.1
1943	141.7	147.0	151.9
1944	155.3	164.2	144.1

* Includes one "gift shop," one "dry goods" store, and one music store.

Exhibit 8

MITCHEL'S STORE, INC.

FURNITURE STORE RATIOS PUBLISHED BY DUN & BRADSTREET, INC.*

Based on Fiscal Year-End Figures for 1946–1947

	Unit	*Upper Quartile†*	*Median†*	*Lower Quartile†*
Current assets to current debt	Times	16.24	4.84	2.72
Net profits to net sales	%	13.54	7.29	3.25
Net profits to tangible net worth	%	32.85	19.94	10.84
Net profits to net working capital	%	48.03	25.11	10.05
Turnover of tangible net worth	Times	3.67	2.52	1.67
Turnover of net working capital	Times	6.76	3.64	2.66
Net sales to inventory	Times	10.8	5.9	4.5
Fixed assets to tangible net worth	%	1.5	5.2	15.2
Current debt to tangible net worth	%	6.9	16.3	40.3
Inventory to net working capital	%	32.3	50.8	73.4
Current debt to inventory	%	34.6	74.4	100.9

* These appear in *Dun's Review*, October, 1947. Used here by permission of Dun & Bradstreet, Inc.

† To obtain these figures, the ratios for the stores were arranged in order of size. The median ratio is the one at the middle of this series. The quartiles are the ratios that were halfway between the extremes and the median (or one quarter of the way from each extreme). In each case the figure used is reached by counting the items, not by averaging the ratios.

Exhibit 9

MITCHEL'S STORE, INC.

INDEXES OF DEPARTMENT STORE SALES AND STOCKS

(1935–1939 Average = 100)

Prepared by the Federal Reserve Bank of New York

	Sales	*Stocks*
April	223	233
May	237	224
June	231	206
July	170	193
August	179	215

Jollum Grocery Corporation

In November, 1946, Francis Connolly, the head of a firm of business consultants in St. Louis, was introduced to Mr. Richard Parrish, the general manager of the Jollum Grocery Corporation. Mr. Parrish asked if Mr. Connolly's firm would work with the executives of the corporation in the next few weeks to review the company's problems, especially questions of policy in obtaining funds. During recent months it had been necessary for the company to make large payments for the purchase of real estate. These payments, combined with the need to finance continuing expansion, had caused the management to have some doubts about its ability to handle the usual expansion of inventory in the winter of 1946–1947.

Mr. Connolly indicated that his firm would like to undertake the work, and an appointment for conferences in the offices of the Jollum corporation was made for the following week. During the interval Mr. Connolly and an assistant made a preliminary investigation of the Jollum Grocery Corporation. They found that it was generally considered to be a highly successful enterprise, chiefly because of its spectacular growth. The predecessor enterprise had been founded as a proprietorship by Mr. Fred Jollum in 1928 to act as a food brokerage firm, and from that year until early in 1936 it had operated in St. Louis as a broker for about a dozen large retail grocery stores. These stores had been persuaded by Mr. Jollum to pool their buying power for the purchase of many staple grocery products.

During 1935 Mr. Jollum met Mr. Parrish, who was at that time the district manager in Chicago for a large chain-store company. Mr. Parrish proposed the idea of going into a wholesaling business by expanding the Jollum company into a corporation. He proposed a voluntary chain in areas south of St. Louis where chain-store activity had as yet been small. Mr. Parrish felt that there was a great opportunity for the

development of mutual relationships between wholesalers and retailers that would preserve some of the values of independent operation and yet permit efficient distribution. Since Mr. Jollum had also been thinking along the same lines, an agreement was shortly reached and the Jollum corporation was formed.

The initial capitalization was made up of stock issued to Mr. Jollum for the net worth of his proprietorship and an equivalent amount of stock issued to Mr. Parrish for cash. Since the intent was to form a voluntary chain, the bylaws of the corporation provided that no stock could be transferred unless it was first offered to the corporation. It was expected that, as additional capital stock was needed, it could be sold to the stores served by the corporation.

The idea that a voluntary chain in the region would be successful proved to be true. Sales increased very rapidly and profits also, as indicated in the following table:

Year	Sales (In Thousands)	Net Profit before Income Tax (In Thousands)	Year	Sales (In Thousands)	Net Profit before Income Tax (In Thousands)
1936	$ 228	$ 1[d]	1941	$1,686	$33
1937	427	1	1942	2,212	49
1938	574	7	1943	2,568	19[d]
1939	857	12	1944	3,273	10
1940	1,248	16	1945	3,725	45

[d] Deficit.

In carrying out his part of the preliminary study, Mr. Connolly's assistant made a brief review of the last published balance sheet of the corporation for December 31, 1945. It showed reasonable relationships for a grocery wholesaling company. At that time the corporation had slightly more debt than was common among such corporations, about $100,000 of which was found to be due to the estate of Mr. Jollum. He had died in 1943, and the trust company that had been named his executor had requested that his stock be repurchased by the corporation. It had, however, accepted 5% demand notes in payment for the shares.

Information with respect to operations in 1946 was somewhat scanty, as the corporation did not publish interim statements. Mr. Connolly did learn that the corporation had bought a warehouse and land in Tulsa, where it had formerly been warehousing in rented property, and that in Memphis it had bought some vacant land along the river while

continuing to operate in a rented warehouse. It had owned its principal office and warehouse in St. Louis since 1942.

The financial service consulted by Mr. Connolly's assistant described the nature of the business as follows:

> The corporation handles about 1,400 ordinary grocery items covering every class of goods handled by the ordinary grocery store, including frozen foods and produce. Meat is not distributed, although most of the stores served sell it. About 800 of the 1,400 items sold bear a private brand copyrighted by the corporation.
>
> The merchandise is purchased either from producers directly or through brokers in large lots. Some of the merchandise, notably coffee, is processed and repacked by the corporation for resale. Merchandise is distributed out of inventory on weekly orders and is not contracted for by the retail stores in advance. The number of retail customers is approximately 250, but we understand that about 50 stores make up about half of the dollar volume of sales.

When the conference at Mr. Parrish's office opened, Mr. Connolly found that a balance sheet as of September 28, 1946, the most recent date at which inventory had been taken, had been made available for his use. Mr. Parrish had included the balance sheet of the preceding September, since he felt that the seasonality of the business was such that a comparison with the year-end figures would not be as informative. These balance sheets appear in Exhibit 1, together with notes which Mr. Connolly made shortly after the conference.

At Mr. Connolly's suggestion, Mr. Parrish arranged for the preparation of a condensed comparative income statement of the corporation for the nine months ending September 28, 1946, and the preceding three fiscal years. These figures appear in Exhibit 2, together with Mr. Connolly's notes.

In describing the events of 1946 that led to the condition in September, Mr. Parrish said that the increase in sales volumes had been expected. The growth in physical volume shipped continued previous trends, and in addition there were further increases in the dollar figures of sales because of price rises. The unexpected reductions of working capital were caused by the purchase of real estate in Tulsa and Memphis. In each of these cities the corporation had been operating a branch warehouse on leased property. In both cases the leases had expired in 1946 and renewals were not possible. A satisfactory warehouse had been purchased in Tulsa, but in Memphis an unsatisfactory substitute had to be rented. At the same time a large parcel of real estate on the river was bought as a site for a warehouse. The company believed that a ware-

house adequate for present volumes could be built there in 1947 for about $80,000.

Both the St. Louis and Tulsa warehouses were larger than was necessary for current volumes of shipments. Fortunately, it had been possible to rent the unused space at satisfactory rentals. Mr. Parrish said that he estimated that these warehouses would not be operated at full efficiency until the sales volume of the company had reached approximately $8,000,000 a year. In the meantime, unneeded space would be rented.

The purchase of the property in Tulsa had been accomplished with the assistance of a $72,000 purchase money mortgage. By Sepetmber 28 the corporation had successfully negotiated for an increase of this mortgage to $80,000. The insurance company which held the obligation had agreed to make this new loan at 4% on 20-year terms. During the negotiation it had indicated an interest in lending on the property in St. Louis and in making a loan at Memphis whenever a building was completed there.

Mr. Parrish said that the sale of stock had been an important source of new funds in 1946. Late in 1945 the corporation had authorized the issuance of $300,000 par value of 4% cumulative preferred stock as well as the sale of additional shares of common stock as buyers might be found. In each case the stock was to be offered only to stores affiliated with the Jollum corporation or their owners. The application of the proceeds of the sales of stock to real estate had changed the original plan to use the money solely for the reduction of the long-term debt of the corporation.

With respect to the debts, Mr. Parrish told Mr. Connolly that the debenture bonds had been adopted as a device for raising money some years previously. The bonds bore interest at 3% and matured five years after the date of issue. Sales had been made only to co-operating retail stores or to the owners of these stores. Experience indicated that at maturity many of the bondholders consented to the issuance of new bonds of similar tenor in place of cash payment. In 1946 a number of the bondholders, on request, had been willing to exchange their 3% bonds for 4% preferred stock. Some had volunteered to do this before the maturity of the bonds.

The demand notes payable to the Jollum estate drew interest at 5%. They were held by a trust company which was the executor. This company had indicated that it desired to have these notes paid as soon as could be done without embarrassing the corporation, and some small

reductions had been made. Mr. Parrish felt that there would be no pressure for immediate reduction but no additional funds could be obtained from this source.

It was the long-run objective of the corporation to pay off long-term debts by the expansion of its capital and the reinvestment of earnings, but Mr. Parrish felt that little additional money could be obtained from the sale of stock in the next few months.

In response to a question put by Mr. Connolly, Mr. Parrish said that the company banked with the Farmers Deposit Bank, a small bank in St. Louis. Legal limitations made it impossible for this bank to extend unsecured loans in excess of $28,000, and the bank's policy was that it would not loan more than $100,000 to any customer on any basis. It was charging $2\frac{1}{2}\%$ on the $91,000 currently outstanding on a loan partially secured by certain inventory items. The bank's president had recently agreed with Mr. Parrish that even more funds might be needed in the next few months. He had offered to arrange an introduction to one of the large St. Louis banks in case the company should decide to request credit from such a source. It was the thought of the bank's officers that such a loan, also on a secured basis, would be arranged so that their bank might participate in it.

Grocery wholesalers generally have peak inventories during the winter and spring. They are reduced in the summer as the time approaches to buy a new season's "pack." There is considerable variation in weekly sales, due to holidays, but no great variation in sales due to other seasons.

Mr. Connolly discussed the Jollum corporation's inventory position with the chief buyer of the organization. He learned that the market was still tight but that deliveries received in August indicated some easing of the seller's market. The buyer indicated that he was buying to meet a sales level of 120% of the 1946 dollar volume, although he was "a little ahead" of himself at the end of September. The peak investment in inventory was usually in June or July, and the buyer said he would like to be able to go as much as $150,000 over present levels, in order to be relieved of financial worries if buying opportunities arose.

Mr. Connolly inquired about the prospect of price declines in 1947 and was told that if turnover continued as high as it had been recently the company could absorb up to a 10% decrease in wholesale prices without going into the red at all. This opinion was based on the assumption that prices would fall off gradually enough to permit the adjustment

Exhibit 1

JOLLUM GROCERY CORPORATION

BALANCE SHEETS AND ADDITIONAL INFORMATION

(Dollar figures in thousands)

ASSETS	*Sept. 29, 1945*		*Sept. 28, 1946*	
1. Cash		$ 54		$ 21
2. U.S. Treasury bonds		109		
3. Accounts receivable, net		113		177
4. Merchandise inventories:				
5. On hand, free	$364		$621	
6. On hand, pledged			82	
7. In transit, paid for	34	398	46	749
8. Total current assets		$674		$ 947
9. Inventory of parts and supplies		4		6
10. Unexpired insurance		3		7
11. Deferred charges		1		8
12. Total miscellaneous assets		$ 8		$ 21
13. Land—St. Louis		77		65
14. Buildings—St. Louis	$ 95		$ 90	
15. Less: Allowance for depreciation	6	89	8	82
16. Land—Tulsa				35
17. Buildings—Tulsa			$118	
18. Less: Allowance for depreciation			1	117
19. Land—Memphis				64
20. Furniture and fixtures	$ 40		$ 62	
21. Less: Allowance for depreciation	14	$ 26	18	44
22. Delivery equipment	$ 29		$ 69	
23. Less: Allowance for depreciation	11	18	19	50
24. Total fixed assets		$210		$ 457
25. Total assets		$892		$1,425

Notes on Assets Items

(Numbers refer to line numbers on the statement.)

1. Small payroll accounts in Tulsa and Memphis average under $3 each.

3. All accounts billed weekly. Few run over two weeks. Reserve ample.

4. Staple and frozen 98%; perishable 2%. About $\frac{1}{2}$ in St. Louis; $\frac{1}{4}$ in Tulsa; $\frac{1}{4}$ in Memphis. All values at the lower of cost or market, by physical inventory.

6. Frozen foods in bonded warehouse.

11. 1946 figure includes deferrable costs of acquiring new properties and placing the mortgage at Tulsa. 20-year write-off.

13–15. Bought in 1942. Present resale value above cost. Sold separate building and land in 1946.

16–18. Bought April, 1946.

19. Bought August, 1946. Plan is to construct warehouse in 1947 to cost $80. Designed for future construction to be added as necessary.

20. To install own refrigeration in St. Louis and Tulsa would take $20.

22. Believed adequate for 1947 volume.

15, 18, 21, 23. Depreciation rate on buildings is 3%; on furniture, etc., about 10%; on delivery equipment, $12\frac{1}{2}$ to $33\frac{1}{3}$%.

LIABILITIES AND CAPITAL	Sept. 29, 1945		Sept. 28, 1946	
1. Trade accounts payable		$ 85		$ 130
2. Notes payable—bank:				
3. Secured			$63	
4. Unsecured			28	91
5. Accrued expenses and interest		7		14
6. Withholding and social security payments	$4		9	
7. Real estate tax accrued	1		3	
8. Federal income tax, last year	2	7	4	16
9. Federal income tax, current year, est.		12		14
10. Due on mortgage within 12 months		14		14
11. 3% debenture bonds due within 12 months		40		53
12. Total current liabilities		$165		$ 332
13. Notes payable—Jollum		99		89
14. 3% debenture bonds, due after 12 months		225		150
15. Mortgage note, St. Louis		56		42
16. Mortgage note, Tulsa				72
17. Total noncurrent debt		$380		$ 353
18. Preferred stock, 4% cumulative				290
19. Common stock		297		400
20. Surplus		50		50
21. Total capital		347		$ 740
22. Total liabilities and capital		$892		$1,425

Notes on Liability and Capital Items
(Numbers refer to line numbers on the statement.)

1. Typical discounts require 10-day payment. Company discounts regularly.

4. Legal limit of Farmers Deposit Bank for unsecured loans.

8. Last quarter installment.

10. Redeemable in full at any time without penalty. Original loan $115. Rate 3%.

11. About $\frac{2}{3}$ usually take new bonds. Many now converting to preferred stock.

13. Cannot be increased.

16. Life insurance co. has agreed to increase to $80, 20-year terms, 4%; annual payment $6.

18–19. 10% common stock dividend paid in stock March 30, 1946. Most of balance of increase bought by customers of the company. Preferred authorized to $300.

Exhibit 2

JOLLUM GROCERY CORPORATION

CONDENSED INCOME STATEMENTS AND ADDITIONAL INFORMATION

(Dollar figures in thousands)

	Year 1943	Year 1944	Year 1945	Nine Months in 1946
1. Net sales	$2,568	$3,273	$3,725	$3,481
2. Cost of goods sold	2,329	2,970	3,378	3,134
3. Gross margin	$ 239	$ 303	$ 347	$ 347
4. Discounts taken, etc.	31	15	26	10
5. Income from coffee roaster	....	....	12	9
6. Gross income	$ 270	$ 318	$ 385	$ 366
7. Operating expenses*	281	296	323	320
8. Discounts given and interest paid	8	12	17	14
9. Total expenses	$ 289	$ 308	$ 340	$ 334
10. Net profit	19[d]	10	45	32
11. Federal income tax	....	7	17	12
12. Balance after income tax	$ 19[d]	$ 3	$ 28	$ 20
	%	%	%	%
1. Net sales	100.0	100.0	100.0	100.0
3. Gross margin	9.3	9.2	9.3	9.9
6. Gross income	10.5	9.7	10.3	10.5
7. Operating expenses	11.0	9.0	8.7	9.2
8. Discounts given and interest paid	0.3	0.4	0.4	0.4
10. Net profit	0.8[d]	0.3	1.2	0.9

* Depreciation and amortization included $7 $11 $11 $15

[d] Deficit.

Notes on Income Statement

(Numbers refer to line numbers on the statement.)

1. Now running to total over $4,500 for year.
3. Recent high margin caused by rising prices. Not likely to be maintained in 1947.
5. Accounts kept separately, although a department of the company.
7. Lost control over costs in 1943. Rate in 1946 adopted to provide for research in frozen foods distribution out of high margin.
12. 10% stock dividend but no cash to common in 1946. All preferred dividends paid currently.

of all prices from producer to consumer on a fairly even basis. A sudden drop in prices would cause considerable loss.

The buyer also told Mr. Connolly that there had been no great changes in the volume of inventory since the physical count had been taken in September but that fairly large shipments would normally be received in the next few weeks. Mr. Parrish said that he thought the company could "find the money" to take care of such increases for a month or so without borrowing funds, but it might mean abandoning the advantages of taking discounts.

As the conference closed Mr. Parrish asked Mr. Connolly to write him a preliminary report which would review the possible sources of funds available to the company and give some tentative recommendations for discussion. Mr. Connolly replied that he would be glad to submit such recommendations. The report, he said, would include, among other things, discussion of the alternative types of loans available as well as the types of institutions that might be interested in the negotiation of actual loans. Perhaps, too, he might be able to suggest changes in company policy that would relieve the need for funds.

Eagle Packing Company, Inc.

The Eagle Packing Company, Inc., was organized in 1923 by Mr. Fred Farley and a few associates in a city in Pennsylvania. At first the company specialized in manufacturing quality pork products, such as sausages and hams. Over the years it broadened its lines by adding beef products. Sales were centered in eastern Pennsylvania, New Jersey, and "upstate" New York. During 25 years of operations the company had never suffered an annual loss on its operations, although its earnings had fluctuated widely.

In 1934, Mr. Farley felt that further expansion should prove profitable, but neither he nor the company had sufficient resources to carry out these plans. Without the assistance of any investment or commercial bankers, Mr. Farley had been able to sell at par 26,746 shares of 7% nonvoting cumulative preferred stock, $100 par, callable at 107, along with some 54,000 common shares. These shares were sold largely through the efforts of Mr. Farley and his sales force to personal friends and business acquaintances. After this sale the capitalization of the company consisted of $2,674,600 of 7%, $100 par, preferred shares and $2,575,965 in common shares, $15 par.

In the late summer of 1945 the company purchased a beef slaughtering plant at Des Moines, Iowa, which it had been leasing since 1942 at an annual rental cost of $62,500. The plant was acquired in exchange for 1,625 shares of 7% preferred stock and 18,375 shares of common stock. In arriving at a sale price, the preferred stock was valued at par and the common stock at $22 per share (its approximate book value) for an aggregate value of $566,750.

Immediately after the purchase of the Des Moines plant, a program of expansion to provide additional branch facilities was inaugurated. In order to secure the $1,250,000 needed for this program as well as $1,250,000 required for additional working capital, $2,500,000 was

borrowed from the Eastern Mutual Life Insurance Company by means of a $3\frac{1}{2}\%$ first mortgage bond issue, with a repayment provision designed to retire the whole issue over 15 years.

The mortgage indenture provided for fixed semiannual payments on January 31 and July 31 of $107,824, including both interest and principal. These bonds were callable at 103 for nine years, declining $\frac{1}{2}\%$ each year thereafter, being 100 during the fifteenth year. The indenture also stipulated that dividend payments could be made only from surplus earned subsequent to November 1, 1944, and then only if, after giving effect to the payment of any dividends, working capital were at least $3,000,000 and the current ratio 1.5.

In August, 1946, in order to provide working capital, 12,000 shares of common stock were offered at $25 to common stockholders. Mr. Farley did not exercise his stock purchase rights in order to allow members of the management to buy the unsubscribed shares. This financing netted the company $300,000 in new money. The company at this time would have preferred to raise more money for working capital but did not wish to go to the bother and expense of SEC registration. See Table 1 for a summary of securities issued from 1934 to 1947. Balance sheet data for 1945 and 1946 are given in Exhibit 1 (p. 375).

Table 1

EAGLE PACKING COMPANY, INC.

SUMMARY OF SECURITIES ISSUED 1934–1947

	Common		Preferred		Bonds
	Shares	Par Value	Shares	Par Value	Par Value
Total outstanding as of 11/1/34	171,731	$2,575,965	26,746	$2,674,600	....
Des Moines purchase (1945)	18,375	275,625	1,625	162,500	....
Eastern Mutual (July, 1945)	....	....	.....	....	$2,500,000
August, 1946	12,000	180,000	.....	....	....
Bonds retired by 11/1/46					$ 129,269
Total outstanding as of 11/1/46	202,106	$3,031,590	28,371	$2,837,100	$2,370,731

As of July, 1947, Mr. Farley held about 40% of the outstanding common shares, the remainder being distributed among 1,400 holders. A fairly active over-the-counter market existed for these shares. Together with the officers, Mr. Farley controlled over 60% of the votes. Although

the preferred stock was held by an almost equal number of holders, an active market had not developed in these shares; and the current holders were largely those who had purchased the shares upon original issue. Exhibit 2 presents a record of quotations for the common stock.

As shown in Exhibit 3, dividends on the preferred stock had been paid currently except in 1938. The rate of common stock dividends had been established at $1.00 per share in 1943 and was raised to $2.00 per year at the beginning of 1947.

The Eagle Packing Company enjoyed cordial relations with three banks from which it borrowed heavily to finance seasonal operations. Reflecting record sales and resultant increased working capital needs, bank borrowings as of July, 1947, had reached an all-time high of $5,000,000, which the banks seemed glad to advance. These loans were unsecured and carried a 2¼% interest rate. In the past the company had always been able to pay off the loans by November 1, the end of its fiscal year; and it was expected that this would be possible in 1947.[1]

In June, 1947, the board of directors approved a $1,250,000 program of expansion to provide beef cooler facilities, additional smoked meat capacity, and the necessary working capital expansion. The facilities were expected to pay for themselves in a short time by lowering of costs and improved service to customers. Mr. Fred Farley was undecided as to the means of financing to be employed. In view of improved security markets, he also wondered whether the financial plan should include any refinancing of the current outstanding issues. Mr. Saxon, the treasurer of the company, was instructed to investigate the possibilities.

Mr. Saxon found that the Eastern Mutual Life Insurance Company would be willing to make a new 3½% loan for $3,750,000, which would, in effect, retire the current bond issue and provide $1,445,910 in

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[1] The following quotation is from J. G. Glover and W. B. Cornell, *The Development of American Industries* (New York: Prentice Hall, 1941), p. 81. Quoted with the permission of the publishers.

"In spite of the fact that a great many meats and meat products are sold within a few days after the purchase of the livestock from which they are produced, merchandise inventories frequently represent the largest class of assets owned by packing companies. Total current assets—including inventories, accounts receivable and cash—will normally make up from 50–60% of the total assets of a meat packing company.

"One other factor influencing the financial policy of meat packing companies is the seasonal accumulation of meat, which takes place during the winter months, when receipts of livestock are heavy. Total of stocks of products stored by the industry are usually from 40 to 100% greater on the first of May than on the first of November. This accumulation of products requires substantial short-term financing by the packing companies. Borrowings are liquidated from the proceeds of sales as stocks are worked down during the summer months."

new money (as of July 31, 1947). The general terms of the loan would be the same as those of the current loan, but the semiannual payments covering principal and interest would increase from $107,824 to $161,737 and the final payment would be in 1962. However, an "after acquired property" clause would be included in the indenture.[2] The insurance company would furthermore be willing to waive the redemption premium on the current issue provided it were replaced by the larger issue.

Mr. Saxon realized that such an increase in the funded debt, added to the short-term bank debt likely to be outstanding, would bring the total debt to about $10,500,000 at the seasonal peak next year if sales continued their present uptrend. He was not certain, however, whether such heavy use of borrowed money represented shrewd use of "leverage" or unconservative finance.

After talking to the insurance company representative, Mr. Saxon arranged interviews at several investment banking firms. None of the bankers was willing to consider the purchase of a straight preferred issue. In their view, individual investors currently were interested in but two types of securities—very low risk bonds and highly speculative "double your money" issues. Individual investors were cool toward securities that fell in between the two extremes.

One firm that Mr. Saxon contacted, Gold and August, made a firm offer, subject to market conditions remaining stable, to purchase up to 175,000 shares, 5% cumulative preferred stock, $25 par, convertible into common $1\frac{1}{2}$ points above the market price of the common on the date of issue and callable at $27.50. (In his calculations, Mr. Saxon assumed that the market for the common would be $36, in which case three preferred shares would be convertible into two common shares.) The issue would be sold to the public at par, with net proceeds to the company of 90%, or $22.50 per share. The offer, however, was conditioned upon the retirement of the 7% preferred stock and no change in the present bond contract.

Mr. Saxon realized that the majority of the people buying such a preferred issue would be doing so with the expectation that still higher earnings were in prospect for the company and that it would therefore be profitable for them to convert the preferred into common in a short

[2] "As security for an issue of bonds, a corporation often mortgages not only property which it owns . . . at the date of the mortgage deed, but it also covenants to extend the lien to property acquired in the future."—J. I. Bogen, *Financial Handbook* (New York: Ronald Press Co., 1949), p. 491. Quoted with the permission of the publishers.

period of time. In discussing the likelihood of conversion, Mr. Saxon learned that conversion seldom took place in large volumes at the option of stockholders, even when there was a profit to be taken. However, the representative of Gold and August stated that the Eagle Packing Company could force conversion by calling the preferred when the conversion would be profitable.

These same bankers made another offer, also subject to market conditions remaining stable, to purchase up to 115,000 common shares at $32 net to the company. The issue would be sold to the public at $35 or $36. The recent sale by an estate of several thousand shares at $40 per share supported the view that 115,000 shares could be sold at $36. A condition of this offer, however, was the retirement of the balance of the mortgage loan of the Eastern Mutual Life Insurance Company.

As he began his consideration of these alternatives, Mr. Saxon attempted to clarify the earnings aspect of the three possibilities by charting their effect upon the earnings per share of common stock in 1948.[3] This chart, he knew, illustrated only one aspect of a complex problem and is presented as Chart 1 (p. 377).

(NOTE: An economic background of the meat packing industry as a whole is given in Appendix A of this case [p. 378].)

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[3] In this year, the interest on the existing bonds would be $77,078. If the new bonds were used, interest would become $129,568.

Exhibit 1

EAGLE PACKING CO., INC.

BALANCE SHEETS

ASSETS	November 1, 1945		November 1, 1946	
Cash	$1,231,639		$1,215,255	
Government bonds	103,864		....	
Accounts receivable—net	2,091,951		2,472,773	
Inventories*	3,050,766		4,194,794	
Cash value—life ins.	239,745	$ 6,717,965	264,862	$ 8,147,684
Investments		25,380		74,875
Property and plant	$7,365,790		$8,243,522	
Less: Depreciation res.	3,088,977	4,276,813	3,300,391	4,943,131
Prepaid expense		357,164		385,357
		$11,377,322		$13,551,047
LIABILITIES				
Accounts payable	$1,037,088		$1,439,370	
Federal income tax	688,228		1,097,106	
Advances to customers	25,169		35,750	
1st mtg. bonds due	129,269	$ 1,879,754	133,843	$ 2,706,069
1st mtg. bonds due to 1960		2,370,431		2,236,588
Reserve for contingencies		62,500		62,500
7% preferred stock, $100 par: 28,371 shares		2,837,100		2,837,100
Common shares, $15 par: 1945—190,106 shares		2,851,590		3,031,590
1946—202,106 shares				
Capital surplus		190,157		310,157
Earned surplus		1,185,790		2,367,043
		$11,377,322		$13,551,047

* Valued at lower of cost or market.

Exhibit 2

EAGLE PACKING CO., INC.

COMMON STOCK QUOTATIONS

As of Last Trading Day of Month

	1944		1945		1946		1947	
	Bid	*Asked*	*Bid*	*Asked*	*Bid*	*Asked*	*Bid*	*Asked*
January	14½	16	18	20	19	22	25	27
February	15½	17½	18	19½	19	22	28	29
March	16	18	18	19½	21	23	28	30
April	16	18	16	18	22	24	28	31
May	17	19	17	18	22	24	33	35
June	19	20	17	19	21	22	35	37
July	19	20	17	19	23	24	41	45
August	18½	20	17	19	24½	26	..	..
September	18½	20	19	20	25	26	..	..
October	18½	20	20	22	24	26	..	..
November	19	20	20	22	25	26	..	..
December	18	20	20½	22½	25	27	..	..

Exhibit 3

EAGLE PACKING CO., INC.

OPERATING RESULTS

(Dollar figures in thousands)

Fiscal Year	Net Sales	Interest Charges in Cost of Sales	Profit before Taxes, Depreciation	Depreciation Charged	Net Profit before Income Taxes	Income Taxes	Net Income	Dividends Paid Pfd. and Com.	Net Income per Share Available to Com. if Full Pfd Div. Paid	Dividends Paid, per Share Pfd.	Dividends Paid, per Share Com.
1936	$22,655	$ 22	$ 446	$177	$ 269	$ 33	$ 236	$230	$0.29	$7.00	$0.25
1937	26,945	41	344	191	153	30	123	187	...	7.00	...
1938	25,976	31	436	199	237	44	193	107	0.03	4.00	...
1939	27,385	35	1,001	215	786	146	640	214	2.64	8.00	...
1940	26,349	42	1,030	254	776	241	535	327	2.03	9.00	0.50
1941	34,934	76	798	255	543	164	379	187	1.12	7.00	...
1942	50,843	92	1,176	255	921	442	479	187	1.70	7.00	...
1943	68,720	116	2,154	264	1,890	1,351	539	359	2.05	7.00	1.00
1944	69,299	107	2,113	274	1,839	1,281	558	359	2.16	7.00	1.00
1945	56,109	105	1,098	283	815	394	421	374	1.17	7.00	1.00
1946	60,424	177	2,817	251	2,566	1,056	1,510[a]	395	6.49	7.00	1.00
1947*	57,826*	169*	2,135*	151*	1,984*	763*	1,221*	301*	5.55*	3.50*	1.00*

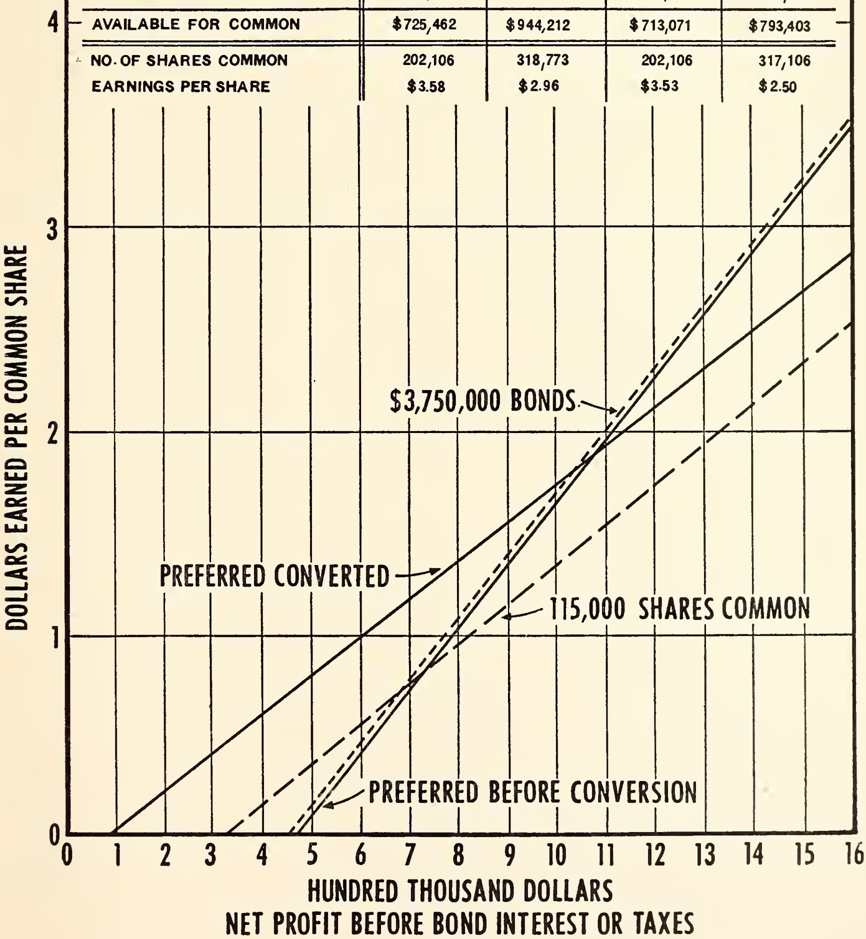
* For six months.
[a] Includes proceeds of life insurance of $65,000.

Chart 1

EAGLE PACKING COMPANY

ALTERNATE PLANS IN 1948 — EFFECT ON EARNINGS PER COMMON SHARE

SAMPLE CALCULATION OF POINTS ON LINES	5% PREFERRED BEFORE CONVERSION	5% PREFERRED CONVERTED	$3,750,000 BONDS	115,000 ADDITIONAL COMMON
NET PROFIT BEFORE INTEREST OR TAXES	$1,600,000	$1,600,000	$1,600,000	$1,600,000
INTEREST IN 1948	77,078	77,078	129,568	
NET TAXABLE INCOME (100%)	$1,522,922	$1,522,922	$1,470,432	$1,600,000
INCOME TAX (38%)	578,710	578,710	558,764	608,000
NET AFTER INCOME TAX (62%)	$944,212	$944,212	$911,668	$992,000
DIVIDEND ON PREFERRED	218,750		198,597	198,597
AVAILABLE FOR COMMON	$725,462	$944,212	$713,071	$793,403
NO. OF SHARES COMMON	202,106	318,773	202,106	317,106
EARNINGS PER SHARE	$3.58	$2.96	$3.53	$2.50



APPENDIX A

ECONOMIC BACKGROUND OF THE MEAT INDUSTRY

The meat packing industry's operations can be roughly divided into three functions, purchasing of livestock, converting the livestock into meat and by-products, and distribution and selling. For the five-year period, 1936–1940, 73.6% of the meat packers' sales dollar went to the purchase of livestock, 25.5% to costs of production including taxes, and less than 1% constituted profit.

Looking at the meat supply situation which constitutes about three-fourths of the packers' costs, it is found that the packer has very little control over this phase of his operations because of the keen competition among packers for the available livestock. The price paid for livestock depends largely upon the supply situation. This factor is more fully discussed as follows:

". . . The amount [of livestock] produced on these farms depends largely upon the amount of feed and forage produced, and the relative price of these feeds, compared with the price of meat animals. A large supply of feed and forage usually means that the farmers make the decision to grow more livestock; a small supply that they will grow less. . . .

"When livestock has been raised and fed to market weights, they must be marketed rather promptly. If kept beyond the proper marketing time they make very inefficient use of additional quantities of feed. . . .

"The short-time swings, as well as the seasonal and annual fluctuations in the number of livestock that farmers send to market, therefore have considerable effect on meat [livestock] prices, since they result in corresponding changes in the supply of meat. . . . The fact that meat packers have no control of supply therefore automatically results in a change in meat [livestock] prices when supplies change, unless offset by a corresponding change in the demand for meat."[1]

As will be observed from the following chart, meat consumption is not subject to violent fluctuations, or in other words, *physical volume* of production is not characteristically cyclical. However, it is true that usually the total value of all meat consumed varies directly with the total disposable income. Therefore, if the physical volume of meat sup-

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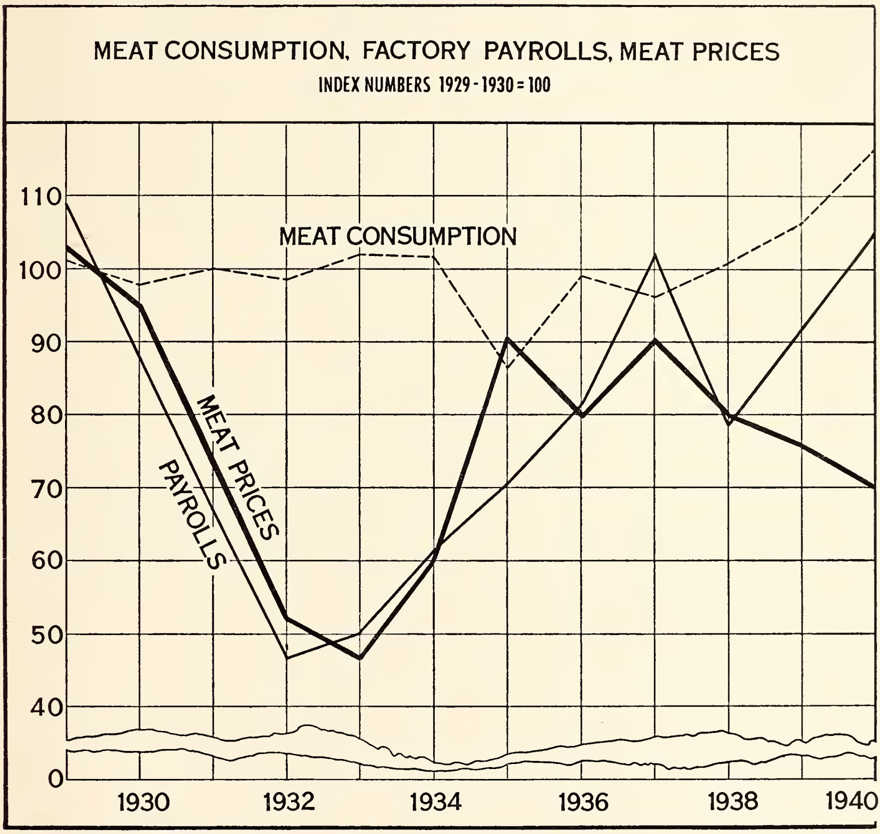
[1] *Meat Price Facts,* by R. J. Eggert, Associate Director, Department of Marketing, American Meat Institute, Chicago, Illinois.

ply should remain constant and payrolls should drop drastically, prices of meat have to drop correspondingly in order to move the supply into consumer channels. This is well illustrated in the following chart for the years 1929 to 1940. (During the 1940's, rationing and price controls have interfered with this process of adjustment.) From this it can be realized that the prices received for the packers' products are on the whole outside the packers' control.

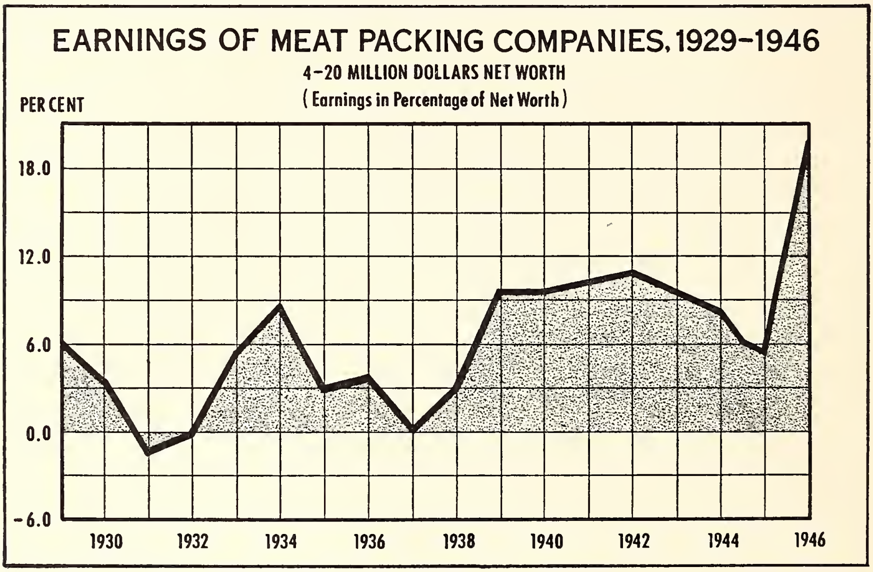


Source: American Meat Institute

From the above discussion it can be seen that in effect the packer is buying in one market over which he has no control, and selling in another over which he has no control. If he were buying and selling the same meat simultaneously, no great problem would be presented. However, actually there is a lag of from a few weeks to months, depending upon the product, between the time he buys the livestock and sells the

derived products. Should the supply or demand condition change unexpectedly during this period, the packer is in the position of having inventory losses or gains—especially if he values his inventory on a first-in, first-out basis. This problem is very acute inasmuch as the packer has no method of hedging against such losses. Many meat packers now use the last-in, first-out inventory method or use inventory reserves to mitigate the influence of these gains or losses.

A rule of thumb in the packing trade is that a packer should secure an average profit of over 2% of net sales. It can be seen that, when meat prices tend to be high, profits tend to be high; and when meat prices slump, profits tend to slump. The cyclical nature of the packing house profits can be seen in the following chart.



Source: Packers and Stockyards Division, U.S. Department of Agriculture

The Dayton Power and Light Company
Morgan Stanley & Co., Incorporated

NOTE.—The following material consists of excerpts, without footnotes, from a Securities and Exchange Commission decision with the same title (8 SEC 950, March 27, 1941) and from the opinions written by the Circuit Court of Appeals, Second Circuit, when the decision of the Securities and Exchange Commission was appealed [*Morgan Stanley & Co., Incorporated* v. *Securities and Exchange Commission,* 126 Fed. (2d) 325, February 20, 1942].

I

FINDINGS AND OPINION OF THE COMMISSION

The questions before us are whether Morgan Stanley & Co., Incorporated, stood in such relation to The Dayton Power and Light Company that there was liable to have been an absence of arm's length bargaining between them with respect to the issuance and sale to the public of $25,000,000 of first mortgage bonds of The Dayton Power and Light Company in February, 1940, . . .

This proceeding was instituted pursuant to Rule U-12F-2 of the General Rules and Regulations under the Public Utility Holding Company Act of 1935, by an order to show cause addressed to The Dayton Power and Light Company and Morgan Stanley & Co., Incorporated. The Dayton Power and Light Company is a public utility subsidiary of Columbia Gas and Electric Corporation which is in turn a subsidiary of The United Corporation.[1] Both Columbia and United are registered holding companies. Morgan Stanley is an investment banker. Prior to our issuance of the order to show cause Dayton had applied to us pursuant to Section 6 (b) to exempt the issue and sale to the public of

[1] Rule U-12F-2, The Dayton Power and Light Company, Morgan Stanley & Co., Incorporated, Columbia Gas & Electric Corporation, and The United Corporation are hereinafter sometimes referred to respectively as the "rule," "Dayton," "Morgan Stanley," "Columbia," and "United." The Public Utility Holding Company Act of 1935 will be referred to as the "Act."

$25,000,000 of its mortgage bonds from the provisions of Section 6 (a) of the Act. The application disclosed that Morgan Stanley was one of the underwriters to whom Dayton proposed to sell the bonds and that Morgan Stanley's participation was to be more than 5 per cent.

The questions raised in this proceeding are most intricate and difficult. Our desire to be thoroughly familiar with the record facts and to probe the ramifications of the problems involved has occasioned long delay.

THE RULE

One of the more serious holding company problems arises out of the frequent existence of inter-relationships between holding company systems and their investment bankers that give rise to considerable doubt whether, in transactions between them, the subsidiary public utility companies in the system have had the advantages of arm's-length dealing. Congress indicated considerable concern about such relationships in various sections of the Act as well as in reports and debates which formed the basis for the Act. These we will discuss in some detail further along in our opinion. In the administration of the Act, one serious difficulty which we have encountered in our efforts to carry out the Congressional intent has involved the timing of issuance of securities. Either because of a maturity date or a call date, or because of threats of market disruptions, we were under pressure to permit the financing to go through in the form and upon the terms proposed.

On the basis of our experience in carrying out the provisions of the Act, we believed that the solution to the problem lay in establishing a mechanism which would sift out in advance the cases of special relationships and neutralize the effects of such relationships wherever found. Accordingly, on December 28, 1938 the Commission adopted Rule U-12F-2 to become effective March 1, 1939. When an investment banker stands in such relation to a public utility company that there is liable to be an absence of arm's-length bargaining between them in an underwriting transaction, the Rule forbids the payment of an underwriter's or manager's fee to such investment banker if its participation exceeds 5 per cent of the total offering; provided, that the prohibition of the rule is not applicable if diligent effort was made to obtain competitive bids for the securities, or if such effort is shown to have been impracticable and certain other conditions are satisfied. In the case before us no effort was made to obtain competitive bids, nor has there been any showing that such effort was impracticable.

As the validity of the Rule cannot be determined except in the light of its applicability to the facts of this case, we shall proceed at once to a consideration of such facts.

THE RELATIONSHIP

The relationship, if any, between Dayton and Morgan Stanley arises out of certain intermediate relationships, namely: (1) the position of Dayton as a subsidiary of Columbia and the position of Columbia as a subsidiary of United; (2) the incentive attributable to leading partners of J. P. Morgan & Co. to secure underwriting business for Morgan Stanley; and (3) the influential position of J. P. Morgan & Co. in the affairs of United. In other words, the argument of counsel for the Public Utilities Division is that Dayton, through Columbia, is susceptible to domination by United; that leading partners of J. P. Morgan & Co. have a strong motive for securing business for Morgan Stanley; and that J. P. Morgan & Co. has occupied such an influential position with respect to United that it has been able to place Morgan Stanley in a preferred position with respect to the underwriting business of companies within United's sphere of influence, including Dayton. Through the links of this chain, counsel for the Public Utilities Division maintain that Dayton and Morgan Stanley stood in such relationship to each other that there was liable to have been an absence of arm's-length bargaining in the underwriting transaction relating to the Dayton bond issue.

We take up each of these propositions in the order stated.

(1) *Dayton is a subsidiary of Columbia, and Columbia is a subsidiary of United.*

Under the Act, a company is automatically given the status of a subsidiary of a holding company if 10 per cent or more of its voting securities are owned, controlled, or held with power to vote, by such holding company.

Dayton's voting securities have been 100 per cent owned by Columbia since 1925; and since May, 1930, at least 19.6 per cent of Columbia's voting securities have been owned by United. Both Columbia and United are registered under the Act as holding companies. The consequences that attach to the status of subsidiary companies of registered holding companies arise out of the statute itself, not out of any determination we may make. If such consequences are to be avoided, it is incumbent upon either the subsidiary company or the holding company to apply to us for an order declaring such subsidiary company not

to be a subsidiary of the specified holding company. No such application has ever been filed with respect to Dayton; and although at one time Columbia filed an application for an order declaring it not to be a subsidiary of United, that application was withdrawn by Columbia before it came to a hearing.

By reason of the status of Dayton and Columbia as subsidiaries of United, therefore, it follows as a matter of course that a person influential in the financial affairs of United would also stand in a similar relationship to United's subsidiaries, and is within the scope of the Rule. Of course, it is not necessary for the purpose of the Rule to find a parent-subsidiary status between Dayton and Columbia and United. The Rule also embraces more subtle relationships which may so link corporations and individuals that there is liable to be an absence of arm's-length bargaining in transactions between them. On the facts, as hereinafter set forth, we also find that such a relationship exists between Dayton and Columbia and United.

(2) *The incentive of leading partners of J. P. Morgan & Co. to secure business for Morgan Stanley.*

Morgan Stanley was formed as an investment banking house by partners of J. P. Morgan & Co. and its Philadelphia firm, Drexel & Co. These firms, forced by the Banking Act of 1933 to elect between commercial banking and investment banking, chose the former. They were therefore compelled to terminate their underwriting business as of June, 1934.

At that time the securities markets were virtually dormant, and when they began to reopen in 1935 the members of the Morgan-Drexel firms entertained hopes that the Banking Act might be amended to permit commercial banks to underwrite and wholesale securities. About July of 1935, however, it became apparent that such an amendment would not be enacted, and the members of the Morgan-Drexel firms concluded that a separate organization should be formed to engage in investment banking. It was agreed among them that certain partners and employees should leave the firms and become directors, executive officers, and employees of the new organization. Some of the remaining partners of J. P. Morgan & Co. agreed to "grub-stake" the new organization by purchasing its preferred stock, and this they did according to their individual means and inclinations.

On September 6, 1935, Morgan Stanley was incorporated, and its organization was completed on September 16. The three principal of-

ficers were Harold Stanley, William Ewing and Henry S. Morgan, formerly partners of J. P. Morgan & Co. They were joined in the new enterprise by two members of J. P. Morgan & Co.'s Philadelphia firm of Drexel & Co., three senior employees of J. P. Morgan & Co., and a staff of employees also from that firm. Harold Stanley became president and director of the corporation, William Ewing became executive vice-president and a director, and Henry S. Morgan became treasurer, secretary and a director. Four of the others became vice-presidents and directors, and one was made assistant treasurer and assistant secretary. All of these persons still occupy their original positions, the only changes occurring to date being the addition in 1936 of two vice-presidents and directors. These were Alfred Shriver, formerly president and a director of Guaranty Company of New York, and Sumner B. Emerson, formerly a vice-president of Fire Association of Philadelphia and associated companies.

. . . At the inception of Morgan Stanley, pecuniary interests in its capital and surplus were held as follows:

Owners	*Amount*		*Per Cent*
Individual partners of J. P. Morgan & Co.—preferred stock	$6,600,000		88%
Officers and directors of Morgan Stanley,			
preferred stock	400,000	$5.33\frac{1}{3}\%$	12%
common stock and surplus	500,000	$6.66\frac{2}{3}\%$	
Total capitalization and surplus	$7,500,000		100%

In August, 1937, the number of common shares was increased to 200,000, and the additional shares were distributed to the then holders of common stock in proportion to their holdings. At the present time the common shares are still held only by the officers and directors of Morgan Stanley and the three largest stockholders, holding 20 per cent each, are Harold Stanley, William Ewing and Henry S. Morgan.

The interests of the partners of J. P. Morgan & Co. in the preferred stock of Morgan Stanley have been reduced, principally by the death of two partners, partly by transfers. On August 31, 1939, partners of J. P. Morgan & Co. owned 30,700 out of the 70,000 shares of outstanding preferred stock, while 20,000 of the outstanding shares were held by the estate of a deceased partner and a total of 3,100 shares were held by two partners in trust. In the meantime the equity attributable to the common stock had increased from the original $500,000 to nearly $3,000,000 so that on the basis of the net worth of Morgan Stanley

as of August 31, 1939, pecuniary interests therein were held approximately as follows:

Owners	*Amount*		*Per Cent*
Living partners of J. P. Morgan & Co., individually and in trust, preferred stock	$ 3,580,000		35.8%
Estate of deceased partner of J. P. Morgan & Co., preferred stock	2,000,000		20.0%
Others, preferred stock	170,000		1.7%
Officers and directors of Morgan Stanley,			
preferred stock	1,250,000	12.5%	42.5%
common stock and surplus	3,000,000	30.0%	
Total capitalization and surplus	$10,000,000		100.0%

Aggregate income in dividends on the preferred stock held by living partners of J. P. Morgan & Co. has ranged from $396,000 in 1935 down to $143,200 in 1939. When the nine partners of J. P. Morgan & Co. invested in the preferred stock, they were as hopeful as the officers and directors of Morgan Stanley that the enterprise would succeed. It was clearly to their own pecuniary advantage to secure as much underwriting business for Morgan Stanley as possible.

. . . .

Our conclusion is that at all times since the formation of Morgan Stanley, the pecuniary interests of the leading partners of J. P. Morgan & Co. have been such that those partners have had a powerful incentive to secure what business they could for Morgan Stanley. We do not deem it necessary to find in this case that the partners of J. P. Morgan & Co. exert an influence over the management and policies of Morgan Stanley. The failure to so find, however, does not weaken the force of our conclusion that there was an identity of pecuniary interest. It is not to be supposed that partners of J. P. Morgan & Co. would have to possess influence over Morgan Stanley to induce it to accept such high-grade underwriting business as they were able to procure for it.

(3) *J. P. Morgan & Co. has occupied such an influential position in United that Morgan Stanley has been placed in a preferred position with respect to the financing of Columbia subsidiaries, including Dayton.*

J. P. Morgan & Co.–Drexel & Co., together with Bonbright & Company, Incorporated, an investment banking house then controlled by Landon K. Thorne and Alfred L. Loomis, organized United in January, 1929. The organizers and an affiliated company initially turned over to United cash in the amount of $20,000,000 and large amounts of voting securities of United Gas Improvement Company, Public Service Cor-

poration of New Jersey, and Mohawk Hudson Power Corporation, causing United to issue to them its preferred and common stock and option warrants in exchange for such cash and securities. The initial board of directors of United consisted entirely of representatives of the Morgan-Thorne-Loomis groups. Shortly thereafter, George Howard was added to the board and elected President of United. He has retained these positions to this date. Having established their representatives on United's board of directors the organizers proceeded to dispose of their holdings of United's preferred and common stock to their clients. But in spite of the organizers' small holdings of United's voting securities, they continued to retain their dominant position on the board of directors, partly through control of the proxy machinery. No opposition was ever encountered from the stockholders, few of whom ever attended meetings in person.

The evidence is conflicting as to what purposes the organizers had in mind when they formed United. The Morgan-Drexel firms had been underwriters for the U.G.I. and Public Service systems for many years, had held minority interests in their securities, and had representatives on their boards of directors. There is evidence that around 1928 outside financiers in the utility business had approached either U.G.I. or Public Service with the idea of buying into those companies, and that there were discussions among the Philadelphia partners of Drexel & Co. as to the dangers that might come from such activities. Early in 1928 J. P. Morgan & Co. purchased substantial additional blocks of U.G.I. and Public Service stock, and discussed with other stockholders the advisability of working in concert.

At about the same time General Electric Company asked J. P. Morgan & Co. to buy a substantial amount of securities of Mohawk Hudson. Thorne and Loomis had been discussing with Morgan partners for some time the benefits to be gained from utility investments, but the Morgan-Drexel firms already had a good many millions of dollars tied up in their portfolio of U.G.I. and Public Service stocks. Rather than increase their own utility portfolio, therefore, they decided to form a holding company to take over not only the proffered Mohawk Hudson securities but also their U.G.I. and Public Service holdings together with the even larger holdings therein of The American Superpower Corporation. This enabled the Morgan-Drexel firms to reduce their portfolio of utility investments without disrupting the market prices thereof, and through the sale of the holding company securities, to realize a sub-

stantial profit on their investment and yet retain and even increase their influential position with the constituent utility systems.

In preparing a memorandum to be used in the sale of United stock, it was of interest to J. P. Morgan & Co. to see how other holding companies lacking in diversification of investments had dealt with that problem in their advertising. On January 2, 1929, Thomas S. Lamont, who had just become a partner of J. P. Morgan & Co. but who had been in its employ for some years, wrote a letter to the firm's lawyer reading in part as follows:

"In this connection the names of two other investment trusts occurred to me, the purposes of which are in a way similar to the one proposed, in that they make little if any pretense of diversification, and their purpose is obviously to insure continued control by the bankers . . . and their clients."

Realistic as this statement seems, there was testimony denying that continued control was among the purposes of the bankers in organizing United. But whatever the purposes, the effect was (*a*) to assure the continuation of the position of the Morgan-Drexel firms in the leadership of U.G.I. and Public Service financing; (*b*) to obtain for J. P. Morgan & Co. the leadership in the financing of Niagara Hudson (which was created by the consolidation of Mohawk Hudson and other upstate New York utilities); and (*c*) to assure to Bonbright & Company, Incorporated, an important participation in all such financing. Later, when the Morgan-Drexel firms went out of the investment banking business and Morgan Stanley was formed, Morgan Stanley succeeded to the leadership in the underwriting transactions of companies in these systems.

United did not acquire the bulk of its holdings in Columbia common stock until May, 1930, when through an exchange offer apparently instigated by P. G. Gossler, then Columbia's president, it obtained nearly 25 per cent of Columbia's outstanding common stock. Before that, however, Gossler had expressed a personal interest in United, buying some of its stock and selling to United some of his personal holdings in Columbia.

On May 14, 1930, the United board caused a letter to be sent to Columbia offering to acquire approximately 25 per cent of the outstanding shares of Columbia's common stock, and to issue in exchange for each share so acquired $\frac{1}{3}$ of a share of United's preference stock and

$1\frac{1}{2}$ shares of its common stock. One of the terms of the offer was that upon consummation of the exchange, Gossler should be elected a director of United. Columbia's board approved the offer and resolved to recommend to the Columbia stockholders "that they deposit at least 25% of their holdings pursuant to said proposal." A circular dated May 16 was sent out to all Columbia stockholders by the Columbia management, urging their acceptance on the ground that:

"It is expected that the close association of The United Corporation with Columbia Gas & Electric Corporation as a result of this acquisition of stock will facilitate the making available of the great natural gas resources of the Columbia System to the large industrial and domestic markets along the eastern seaboard.

"Your Board of Directors believe that the proposal made by The United Corporation is of advantage to Columbia Gas & Electric Corporation and its Shareholders. . . ."

Stanley, who was then a member of the Columbia board and executive committee, a partner of J. P. Morgan & Co. and admittedly an influential factor in (though not then formally a director or officer of) United, approved the form and content of this letter to stockholders. Gossler was one of the officers who signed the letter, and was also one of three Columbia officers who set themselves up as a stockholders' committee to work for the success of the plan. This committee employed J. P. Morgan & Co. as depositary. Columbia itself agreed to and did share all expenses equally with United, including a fee of $200,000 to J. P. Morgan & Co. The result of the transaction, in respect of which Columbia paid expenses to the extent of $178,684.06, was the acquisition by United of over 2,000,000 shares of the outstanding common stock of Columbia. Gossler was duly elected to the United board of directors.

From the foregoing and from the testimony it appears that Columbia was hopeful of expanding its business through contacts and leadership which it would gain by joining the United group. For whatever purpose the acquisition by United was made, it did not result in an immediate transfer of Columbia's financing to the Morgan-Drexel or Bonbright interests.

Guaranty Company of New York had been Columbia's investment banker since 1922, and continued as such until it was dissolved as a result of the Banking Act in June, 1934. Meantime, no effort was made by J. P. Morgan & Co. to obtain Columbia's underwriting business for

itself or to participate in that which was headed by the Guaranty Company.

Stanley, who as president of the Guaranty Company had handled Columbia financing prior to 1928 (at which time he became a Morgan partner), testified that in his experience with J. P. Morgan & Co. the firm had never approached a company for underwriting business where such company already had a satisfactory banking relationship with others; and that he knew personally that Columbia had satisfactory relations with the Guaranty Company. It may well be supposed, moreover, that J. P. Morgan & Co. would not be inclined to compete with the Guaranty Company, which was a subsidiary of Guaranty Trust Company, a large and friendly institution on whose board at least two Morgan partners sat.

After the Guaranty Company had gone out of the investment banking business, however, Stanley told Gossler in the summer of 1935 that he and others of J. P. Morgan & Co. planned to go back into the investment banking business. Gossler told his associates at Columbia that if that happened, he would probably want this new organization to take the leadership in a refunding operation then contemplated for Dayton. The refunding operation in question had been first undertaken with other investment bankers but had been postponed in April because of the impossibility of getting a satisfactory commitment from the bankers prior to the date for publishing the notice calling the outstanding bonds for redemption. Negotiations with these bankers were thereafter continued during the summer with the idea of getting out the issue in the fall. Meanwhile these bankers were informed of Gossler's tentative decision, in which the other officers of Columbia and Dayton concurred, and a few days after public announcement of the formation of Morgan Stanley, it was arranged that Morgan Stanley should manage the Dayton issue. This was a $20,000,000 issue of Dayton $3\frac{1}{2}\%$ bonds due 1960, offered to the public in October, 1935.

Columbia has continued since then to have Morgan Stanley lead its subsidiaries' bond issues, and its officers, according to their own testimony, have not thought seriously about employing any other underwriter for that purpose.

Since the present relationship of Morgan Stanley with Dayton and Columbia grew out of the Dayton bond issue of 1935, it is pertinent to examine the circumstances that might have led to Columbia's selection of Morgan Stanley as leading underwriter at that time. Counsel for the

Public Utilities Division maintain that the selection was made because of existing affiliations, while Dayton and Morgan Stanley contend that it was because of the confidence the Columbia officers placed in Stanley personally and in others who went into the new organization with him, and because Columbia wanted the services of a strong firm with adequate capital. There is no real inconsistency in these two contentions, and each of the reasons given undoubtedly played its part.

It was on September 10, 1935, that Gossler, in behalf of Columbia, went to Stanley and arranged for Morgan Stanley to manage the underwriting syndicate for the proposed issue. On that date Stanley was still a partner of J. P. Morgan & Co., for though the formation of Morgan Stanley had been announced, the corporation had not yet been organized for business. On that date seven of the eight directors of the United board were: Harold Stanley, George Whitney and Edward Hopkinson, Jr., all partners of J. P. Morgan & Co.; their fellow organizers of United, Landon K. Thorne and Alfred L. Loomis; George Howard, who was chosen by both groups to be president of United; and F. L. Carlisle, chairman of Niagara Hudson (a subsidiary of United) and of Consolidated Gas Company of New York (in which United held a substantial interest and which has since changed its name to Consolidated Edison Company of New York). That had also been the situation when, a few months earlier, Stanley had informed Gossler that he and others of J. P. Morgan & Co. were probably going back into the underwriting business in the fall.

On the other hand it is urged by respondents that such matters had nothing to do with the selection of Morgan Stanley as leading underwriter for the Dayton bond issue of 1935. Three days after that selection had been made, Stanley's resignation from the firm of J. P. Morgan & Co. took effect, and a few days later he resigned as a director of United. He had had a close personal and business relationship of long standing with Gossler long before he became a partner of J. P. Morgan & Co., as Gossler had been a friend and former employee of Stanley's father. In 1922, when Columbia's predecessor company terminated its banking relations with A. B. Leach & Co., Stanley was president of Guaranty Company and an officer of Guaranty Trust Company, and it was testified that it was largely for that reason that Gossler established banking relations with Guaranty for the Columbia system. Stanley personally worked on Columbia financing for some years before going over to J. P. Morgan & Co. He was on Columbia's board of directors and execu-

tive committee from 1922 until February 1935, and was held in high esteem by the management. Edward Reynolds, then executive vice-president and now president of Columbia, had worked under him at the Guaranty Company years before.

Accepting the argument that all these and other similar considerations were influential in the original selection of Morgan Stanley, the conclusion is nevertheless inescapable that J. P. Morgan & Co. in September, 1935, had such an influential position in the management of United that Morgan Stanley was placed in a preferred position with respect to its selection as leading underwriter for the Dayton bond issue of 1935, and we so find.

We also find that Morgan Stanley was in a preferred position with respect to its selection and its conduct of negotiations as leading underwriter for bond issues in the amounts of $35,000,000 and $10,000,000 in 1936 and 1937, of Cincinnati Gas & Electric Company, another Columbia subsidiary. In 1936, Dayton sold preferred stock with W. E. Hutton & Co. as leading underwriter. The record shows, however, that Columbia officers spoke to Morgan Stanley representatives about this proposed issue beforehand, while the issue was still under consideration and plans were being made to use W. E. Hutton & Co. Morgan Stanley, in keeping with its general practice of not participating in equity security underwritings, agreed that it would not be interested in the preferred stock issue. In March, 1937, Dayton placed $1,500,000 bonds privately. Apparently this small private placement, however, was not effected until the matter had been talked over with Morgan Stanley representatives. Our finding with respect to Morgan Stanley's preferred or inside position is based not only upon the continuous banking relationship then existing between Columbia and Morgan Stanley, but also on the fact that at the time of the underwriter's selection in those issues, four of the five directors on the United board were George Whitney, Landon K. Thorne and George Howard, whose connections have already been described; and Thomas H. Stacy, an interim director elected to make up a quorum, and who had previously been employed by Howard and was serving as United's bookkeeper.

It remains to be seen what the position of Morgan Stanley was in November, 1939, when it was selected as the leading underwriter for the Dayton bond issue of 1940.

The question whether, with respect to the Dayton bond issue of 1940, the relation between Dayton and Morgan Stanley was such that

there was liable to have been an absence of arm's-length bargaining between them within the meaning of paragraph (a) (3) of the Rule.

There can be no question but that Morgan Stanley had a preferential position over other underwriting houses when the time came for Columbia to select a leading underwriter for the Dayton bond issue of 1940. For one thing, it was in a preferred position because of its historical relationship to United and the Columbia system. For another, it was in a preferred position in the sense that continuous investment banking relations still existed between it and the Columbia system and the Columbia officers gave no serious thought to seeking other investment bankers.

Aside from the historical and continuing banker relations, we find other evidence of a special relationship existing between Columbia and Morgan Stanley at the time the latter was selected to lead Dayton's bond issue of 1940. On March 28, 1938, the day of the United States Supreme Court decision in *Electric Bond and Share Co.* vs. *SEC* upholding the constitutionality of the registration provisions of the Holding Company Act, United registered as a holding company under the Act and Whitney and Thorne resigned from the United board.

Elimination of banker influence over holding company and utility managements is a duty given us by Congress. Section 17 (c) of the Act provided the initial step in that direction by prohibiting registered holding companies and their subsidiaries from having officers or directors with banking connections except where the Commission decided that there would be no adverse effect upon the public interest or the interest of investors or consumers. Apparently in view of this provision, George Whitney resigned from the United board of directors. In our opinion, however, that resignation did not sever the special relationship that existed between the Morgan interests and United.

This problem of banker domination or special influence is not new nor is it limited to the utility field. It has been demonstrated in similar instances that the mere fact that a banker cannot sit on the board of directors of a client company does not necessarily change the banker's influential position with respect to his client. For instance, Section 10 of the Clayton Anti-Trust Act provides, in effect, that if a banker sits on the board of directors of a common carrier company, his firm may not underwrite the securities of that company in amounts of more than \$50,000 in any one year, except after competitive bidding. The reports of the Senate Committee investigating railroads, holding companies and

affiliated companies show that absence of official board representatives because of this Clayton Act provision did not prevent investment bankers from continuing to dominate the financial policies of railroad systems.

On the board of United at the time of the present underwriting transaction there were five directors: George Howard, president of United practically since its inception; F. L. Carlisle and Roy K. Ferguson, chairman and president, respectively, of the St. Regis Paper Company and affiliated interests, which control 7.9 per cent of United's voting securities, the largest block held by any unified group; John J. Burns, a former general counsel of this Commission, presently engaged in the general practice of the law and retained as counsel for United; and Edward H. Luckett, who had come to United recommended by an attorney whose firm acted as counsel for Niagara Hudson. The original election of Howard, Carlisle and Ferguson had been approved by partners of J. P. Morgan & Co., and both Howard and Carlisle had done business with the Morgan-Drexel firms for years. Howard's relationship to the Morgan interests appears to have been intimate. Originally placed on the United board as president by the Morgan and Thorne-Loomis groups, the record shows his reliance on George Whitney, leading representative of J. P. Morgan & Co. on the United board. Despite Whitney's resignation from the board of United, Howard's behavior toward Whitney in regard to United matters, as we shall hereinafter relate, has been that of a man who feels that he owes Whitney courteous fealty.

Carlisle came in contact with J. P. Morgan & Co. when that firm, representing United's large interest in Mohawk Hudson securities, participated with Carlisle, the Schoellkopfs and others in organizing Niagara Hudson Power Corporation, a subsidiary of United. Niagara Hudson was the result of a consolidation between several upstate New York utilities, among which were Mohawk Hudson and Northeastern Power Corporation. Carlisle had for some years been president of Northeastern, and represented it in conferences with the Morgans and others in formulating the plan of consolidation. He was made chairman of the board of Niagara Hudson at its inception and has held that position ever since. In 1930 he was first elected to the United board of directors along with the other titular heads of companies in which United was substantially interested. At about the same time he and George Whitney were elected to the board of trustees of Consolidated Gas Company of

New York (now Consolidated Edison Company of New York), and in 1932 Carlisle was made its chairman. Since its inception Morgan Stanley has been the almost invariable leader in both Niagara Hudson and Consolidated Edison public debt financings.

The record indicates that both Howard and Carlisle have frequently relied on George Whitney, a leading partner of J. P. Morgan & Co., and formerly the principal representative of J. P. Morgan & Co. on the United board. Although Whitney resigned from the board of United on March 28, 1938, the following facts cause us to believe that only the outward appearance of a changed relationship between J. P. Morgan & Co. and United had thus been effected.

For about six months after the resignations of Whitney and Thorne, reports which were ordinarily sent only to directors of United continued to be sent to them. George Howard testified that this was done by mistake and that when he found out about it he stopped it.

Yet the influence of George Whitney did not cease thereafter. In August, 1938, United received a letter from William O. Douglas, then Chairman of this Commission, relating to compliance by United and its subsidiaries with Sections 11 (b) (1) and 11 (b) (2) of the Holding Company Act. Thereafter a reply to that letter was composed by the board of directors of United in which there was outlined a future program for United. After that reply had been prepared Howard showed it to Thorne and also went to Whitney and submitted it to him for advice and suggestions. This took place around November, 1938. A program for meeting the integration provisions of the Act was, of course, of great importance to United and its subsidiaries. Of what importance it might have been to J. P. Morgan & Co., at that time a commercial bank, is not clear. Yet Whitney who had left the United board some eight months before was consulted by the president of United prior to forwarding an integration program to the Commission. If, as this incident might indicate, Whitney's advice continued to be regarded as influential, it would appear that members of the United board were not yet free from the influence of J. P. Morgan & Co.

In August, 1938, United effected a so-called quasi-reorganization which involved the write-down of the carrying value of United's investments by some $400,000,000. Howard went to Whitney prior to putting the program into effect and talked over this situation. It was testified that since the result of the write-down was to stop the payment by United of dividends on its preferred stock for which J. P. Morgan

& Co. were paying agents, Howard went and explained this to Whitney "only because I knew many inquiries would come to his firm about the paying of those dividends and I wished him to understand it." Embarkation upon this quasi-reorganization, like the integration program, was a momentous step by United. It is noteworthy that once again Whitney, no longer formally associated with United, was sought out before the step was taken by United. It is at best doubtful whether J. P. Morgan & Co.'s interest in the quasi-reorganization as paying agent required consultation with George Whitney, a member of the firm, before United finally decided to effect this financial program. We think the incident is one more indication that J. P. Morgan & Co., through George Whitney, continued to wield influence in the determination of United's significant affairs.

The sequel to United's quasi-reorganization also involved George Whitney. Due to the quasi-reorganization, a deficit in United's consolidated earned surplus account resulted and dividends could not be paid. Consequently, cash accumulations, which could not be paid out in dividends, increased to about $8,000,000. United had on file with this Commission in the early part of 1939 an application under Rule U-9C-4 for permission to engage in a program of investing this cash in non-utility securities. Howard's testimony shows that he consulted Whitney about this program too. His explanation was that opposition to this projected program had arisen in Philadelphia and he believed that Whitney might suggest how the opposition might be eliminated.

The continued existence of a special relationship between Morgan Stanley and United and its subsidiaries is made clear by a review of the bond and debenture financings by companies in the United group. It is a matter of record that Morgan Stanley is not favorably disposed toward underwriting equity securities. Since Morgan Stanley's underwriting business rests nearly entirely upon debt securities, we have attempted to analyze such security issues by the United group companies. The record in this proceeding covers the debt financings of subsidiaries in the Columbia Gas & Electric, Niagara Hudson, Public Service of New Jersey, and United Gas Improvement systems, all of which are subsidiaries of United. In addition, the record covers debt financings by companies in the Consolidated Edison Company of New York system. We have also included the debt financing record of companies in The Commonwealth & Southern Corporation system.

The record shows that from September 1935, the date of the for-

mation of Morgan Stanley, to February 1940, the close of the hearings in this proceeding, Morgan Stanley has been the leading underwriter in every public financing of bonds or debentures by these United companies except in three instances. The three exceptions involved the issuance of securities by Connecticut Light & Power Company and were underwritten in each instance by Putnam & Co. and Scranton & Co., underwriters located in Connecticut. These three exceptions are probably attributable to the strong policy of promoting local control expressed in the Connecticut statute which provides that no foreign holding company shall control or interfere with the operations of Connecticut gas and electric companies, like Connecticut Light & Power Company. In view of this statutory provision, it is not hard to understand why Morgan Stanley, through United influence, did not head Connecticut financings.

The significant uniformity of underwriting by Morgan Stanley of the above-mentioned United companies is, of course, true only of publicly offered debt security issues. In the past several years, there have been several long-term private financings by these companies. Careful analysis of these private placements reveals that nearly all of them have been for relatively small amounts, only five of them exceeding $10,000,000 in amount. Of these, the only large private placement took place in the fall of 1939 when the outbreak of the European war made the public markets unstable and public offerings were risky. It is also noteworthy that one of these substantial private placements was made by Connecticut Light & Power Co. We have already considered the special local statutory considerations which govern the operations of Connecticut utilities. Finally, it appears that two other substantial private placements were made by subsidiaries of Consolidated Edison Company of New York which is not a statutory subsidiary of United. We believe that the private placements listed in this record are not inconsistent with the existence of a relationship between Morgan Stanley and subsidiary companies in the United group such as is embraced by our Rule. This special relationship might well exist without resulting in exclusive participation by Morgan Stanley in all United system financings.

In conclusion, it should be noted that Morgan Stanley has not headed the financing of any public utility company, as defined in the Act, except subsidiaries of United and companies in the Consolidated Edison and Commonwealth & Southern systems. Confinement of Morgan Stanley's underwriting leadership of utility securities to companies in the orbit of United is particularly interesting in view of repeated

testimony by respondents in this record that Morgan Stanley was successful in obtaining United system financings only because it was a strong firm with adequate capital and furnished satisfactory services.

There are, of course, powerful economic incentives for investment bankers to strengthen their influence over the management and policies of holding companies and their subsidiaries. Not only does such influence assure the banker of the profits from underwriting, but there are additional emoluments which come from the ability to select custodians, depositaries, transfer agencies and coupon and dividend paying agencies. This is a type of financial patronage which customarily goes to the banker who is able to exert influence over the financial policies of a utility system. In connection with the present proceeding, it is noteworthy that J. P. Morgan & Co. has always been the transfer and dividend paying agent for the United Corporation. From its very inception, United Corporation has maintained a substantial deposit account with J. P. Morgan & Co. From 1934 Columbia Gas & Electric Corporation has maintained a sizable deposit account with J. P. Morgan & Co. And J. P. Morgan & Co. has always been custodian for securities owned by United. J. P. Morgan & Co. has also been the coupon paying agent for bond issues of numerous companies in the United group.

This brings us down to the Dayton bond issue of 1940 which occasioned the Commission's order to show cause pursuant to Rule U-12F-2. This involved the issue and sale by Dayton of $25,000,000 principal amount of First Mortgage Bonds, 3% Series Due 1970, to underwriters for resale to the public. The bonds were sold to a group of 38 underwriters, headed by Morgan Stanley, at a price of 102¼. They were offered to the public at a price of 104, resulting in a spread of 1¾ points, or underwriting discounts or commissions totaling $437,500. Of the spread of 1¾ points, Morgan Stanley was to receive ¼ of a point for services as syndicate manager; underwriters, including Morgan Stanley, were to receive ⅞ of a point for wholesale sales; and ⅝ of a point was to be received for retail distribution. The total fees to be received by Morgan Stanley, upon successful placement, aggregated $100,562.50.

It was estimated that, subject to certain qualifications, the refunding portion of the proposed financing would effect an annual saving to Dayton of approximately $48,000 (after allowing for federal income taxes). Dayton also benefited from the extension of the maturity date of $19,015,000 of its previously outstanding debt from 1960 to 1970.

Some of the circumstances surrounding this security issue have

caused us concern. The amount of new money involved was about $5,700,000. It appears from the record that when Morgan Stanley was first approached in regard to the instant financing, the Columbia officials had in mind a security issue of either stocks or bonds to raise only this new money. Morgan Stanley advised that bond financing for the new money was sound. And Morgan Stanley on this occasion also suggested refunding outstanding Dayton bonds in the same financing with the new money issue. R. H. Delafield, financial Vice-President of Columbia, testified that Columbia officials had previously made many studies in regard to refunding the $19,015,000 outstanding Dayton bonds.

Dayton, of course, got cheap money which cost it only 2.91 per cent per annum. But in order to obtain this cheap money it had to pay substantial call premiums of $855,675, and expenses of about $125,000. The maturity date of the refunded debt was extended 10 years. Yet the refunded debt was not to mature until 1960, scarcely a pressing obligation requiring refunding. Dayton's annual saving of $48,000 over the life of the refunded bonds, approximately $1,000,000, is to be compared with the Morgan Stanley commission of $100,562.50 and the $336,937.50 which other underwriters and dealers obtained from the financing. Dayton's savings should also be considered in the light of the cost of the refunding to investors in these Dayton bonds. Investor good will, often deemed an attribute of the public offering method as distinguished from private placements, is scarcely likely to be encouraged by frequent refundings accompanied by small savings to the issuer.

Although these facts have caused us concern, we recognize that the price of 104 to the public and $102\frac{1}{4}$ to the company were not discernibly out of line with the prevailing market, and the spread of $1\frac{3}{4}$ for the underwriters was among the lowest of those taken on comparable public utility issues during the last five years. Of course most of these negotiations took place while the hearings in this proceeding were being conducted, and that circumstance must have affected the outcome.

II

OPINIONS OF THE CIRCUIT COURT OF APPEALS

Following the promulgation of the above opinion, the matter was appealed to the Circuit Court of Appeals. A majority of the three-judge court affirmed the SEC decision. Separate opinions were written by each judge. Judge Learned Hand, one of the majority, said in part:

". . . , there was 'substantial evidence' to support the finding; that is to say evidence from which a reasonable man might conclude that such a chance existed and that the danger was immediate enough to make its removal 'appropriate.' I do not say that personally I should have come to that conclusion, but there had been enough in the relations between the United Company and the Morgan firm to permit the conclusion that the familiarity, recourse for advice, reliance, control and habitude of the past might perhaps unconsciously prove the casting straw. Congress appears to me to have been jealous of the results of the slow cumulation of such factors and to have wished to endue the Commission with power to decide when it was the course of prudence to eliminate the possibility of its influence. The Supreme Court in decisions of which *Gray* v. *Powell,* 62 S. Ct. 326, is the latest, has unequivocally set the narrowest limits upon our review in such situations. The vague outlines of the issue itself, coupled with this circumscription of our powers, leaves us little or no scope.

. . . .

Judge Chase, dissenting, said in part:

It is obvious that, by the statutory definition of affiliate in Section 2 (a) (11) (D) of the Act, 15 U.S.C.A. Section 79b (a) (11) (D), as "any person or class of persons that the Commission determines, after appropriate notice and opportunity for hearing, to stand in such relation to such specified company that there is liable to be such an absence of arm's-length bargaining in transactions between them as to make it necessary or appropriate in the public interest or for the protection of investors or consumers that such person be subject to the obligations, duties, and liabilities imposed in this chapter upon affiliates of a company." Congress has delegated to the Commission very broad and comprehensive power to declare who is, or is not, within the reach of the statute. For present purposes, I shall assume that this delegation of power is as full and complete as it may be and still be within the constitutional limitations upon Congress recognized in *Schechter Poultry Corp* v. *United States,* 295 U.S. 495, 55 S. Ct. 837, 79 L. Ed. 1570, 97 A.L.R. 947, and *Panama Refining Co.* v. *Ryan,* 293 U.S. 388, 55 S. Ct. 241, 79 L. Ed. 446. Even so, there must be some standard of interpretation less vague than the Commission's uncontrolled discretion. Compare *Champlin Refining Co.* v. *Corporation Commission of Oklahoma,* 286 U.S. 210, 52 S. Ct. 559, 76 L. Ed. 1062, 86 A.L.R. 403; *A. B. Small Co.*

v. *American Sugar Refining Co.,* 267 U.S. 233, 45 S. Ct. 295, 69 L. Ed. 589; *United States* v. *L. Cohen Grocery Co.,* 255 U.S. 81, 41 S. Ct. 298, 65 L. Ed. 516, 14 A.L.R. 1045; *International Harvester Co.* v. *Kentucky,* 234 U.S. 216, 34 S. Ct. 853, 58 L. Ed. 1284. What is 'liable to be or to have been' is, indeed, an elastic expression which, when applied to the rather uncertain concept of what may be 'such an absence of arm's-length bargaining . . . as to make it necessary or appropriate in the public interest' to impose upon one the statutory status of an affiliate, gives the whole a meaning still more elusive. For that very reason it is especially important for a reviewing court to make sure that the Commission's order has substantial evidence to support the findings of fact upon which it is based. Only if there is substantial evidential support for them are they conclusive. 15 U.S.C.A. Section 79 x (a). And this means support more firm than that afforded by suspicion, conjecture or but a scintilla of evidence. "It means such relevant evidence as a reasonable mind might accept as adequate to support a conclusion. . . ."

The assumption of uncontrolled power has in this instance led the Commission to dispense with essential evidence in making its order and to arrive at a result unsupported by the facts under the law. That makes it necessary to review the facts briefly.

The petitioner was organized by the partners of J. P. Morgan & Co., and they continued to have such an interest in its affairs that I agree there is evidence which would support a finding that, for the purpose of Rule U-12F-2, it and the Morgan firm may fairly be treated as one. That is by no means true, however, in respect to Dayton. There was no intimate relationship by way of stock interest. The Morgan partners had but a negligible, minute stock interest of less than ½ of 1% even in United, and United owned only some 19.6% of the voting stock of Columbia Gas & Electric Corporation, of which Dayton was a wholly owned subsidiary. It is true that there had been in the past satisfactory business transactions between the men in what may be called generally the Dayton management and what may be equally generally called the Morgan firm. No doubt there were also personal friendships and it is scarcely to be doubted that what is often called goodwill in business was present. This would naturally lead Dayton to consider consulting the petitioner concerning this financing operation with a view to learning whether it was a feasible one and whether some agreement to have the petitioner undertake it could be reached. That was done and an agree-

ment was made under which the petitioner did do the work both, as is conceded by all, well and at a reasonable cost. The evidence will support no contrary findings which are of fact alone and no such findings were made.

And so far as the present petition is concerned, it is to be taken for granted that the bond issue, in amount and otherwise, was in the public interest. It had been authorized by the Public Utilities Commission of Ohio and it had the approval of the Securities and Exchange Commission to the extent of an order approving an application for exemption under Section 6 (b) of the Act, 15 U.S.C.A. Section 79f (b). *In re The Dayton Power and Light Company,* 6 SEC 787. Obviously it was entirely proper for Dayton to sell these bonds and it was reasonable, if not absolutely necessary for Dayton to engage some underwriter to do that. If not the petitioner, someone else in that business. Consequently, one would naturally look for evidence in support of this order to indicate the likelihood that, if the petitioner did it, the work would not be as well done or would not be as economically done or would in some way not be as beneficial to Dayton and to the public as it would be if done by someone else. This record is barren of any such evidence.

In the absence of proof, worthy of the name, to show that the petitioner had any means by which it could bend Dayton to its will, the Commission at long length, by extremely tenuous and subtle deductions, finally guessed itself into believing that there were subtle relationships which supported its ultimate conclusion that the petitioner should be denied its fee under Rule U-12F-2. Its opinion as filed discloses, without expressly admitting, that the Commission merely suspected what it concluded in this regard. The only tenable alternative is that it acted on information it had which was not in evidence. If so, the order is palpably erroneous. As Mr. Justice Brandeis said in the Chicago Junction case, 264 U.S. 258, 263, 44 S. Ct. 317, 319, 68 L. Ed. 667, "Facts conceivably known to the Commission, but not put in evidence, will not support an order. *Interstate Commerce Commission* v. *Louisville & Nashville R.R. Co.,* 227 U.S. 88, 93, 33 S. Ct. 185, 57 L. Ed. 431." And as the same learned justice also said in the same case ". . . to make an essential finding without supporting evidence is arbitrary action."

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